STRATEGY FOCUS

Themes for 2023 as seen by the Eco&Strat team

2022 in review: a failed free kick. A year ago, our forecasts for 2022 were pretty bullish. They were quickly rendered obsolete, however, by a series of shocks that caused a slump in activity and a leap in inflation. Markets were gripped by risk aversion and few assets offered a safe haven.

2023 should start well for bonds. Our scenario envisages growth slowing without tipping into a major recession, inflation falling rapidly but with persistent underlying price pressures, while central banks remain watchful. This environment, coupled with a still high degree of uncertainty, will continue to benefit bonds. Long-term rates could increase further at the beginning of the year, notably with the *Quantitative Tightening* policies of the central banks, before easing again with the fall in inflationary tensions and activity that would remain moderate.

Return to a negative correlation between equities and fixed-income. The return of growth/inflation procyclicality, with growth and inflation falling in tandem, should restore the negative correlation between equity and bond prices. This is good for portfolio managers who will be better able to diversify risks. After a first half-year favourable to bonds, equities should recover their relative appeal.

Positive real rates are good for defensive assets. Central banks will want to keep real interest rates in positive territory across all maturities to continue bearing down on inflation. This will favour well-rated corporate bonds and indices of value stocks.

Dollar likely to shed some of its recent gains. Having rallied strongly this year, the dollar is likely to slip back slightly against other currencies, notably the euro, as geopolitical and energy risks abate and markets price in rate spreads that are less favourable to the United States.

Emerging markets: rocky road to recovery in China, mixed picture elsewhere. China's exit from its zero-Covid policy could be a stop-start process and hampered by the weakening of its property and infrastructure sectors. Other emerging financial markets can expect to continue their relatively healthy performances over the year as the Fed (in all likelihood) slows its policy tightening, south-east Asia booms and yields remain relatively attractive.

Residential property markets hit by rate hikes. In developed economies, the money households have to spend on housing is being eroded by high housing prices, inflation eating into disposable income and rising interest rates.

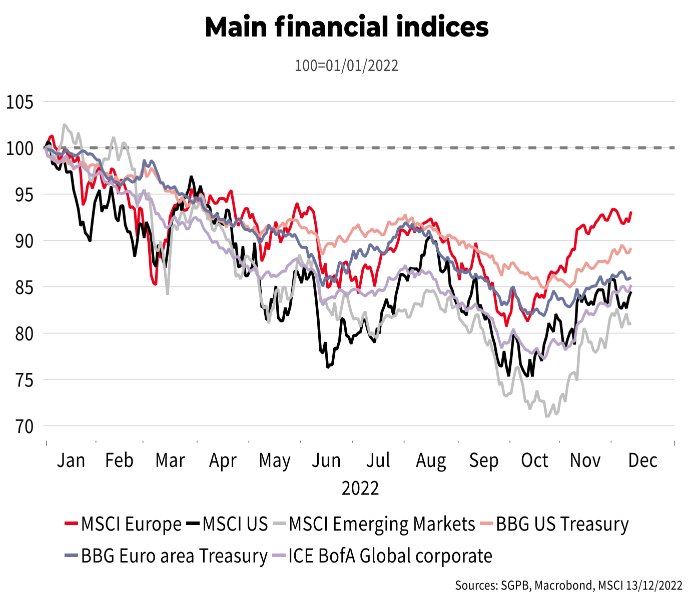
2022 IN REVIEW: A FAILED FREE KICK

A year ago, our economic and financial forecasts for 2022 were pretty bullish. Growth was expected to be strong as lockdowns ended and citizens rushed to spend their Covid savings, as inflationary pressures, then seen as transitory, faded and as monetary and fiscal policies ticked gradually back to normal. At the end of 2021, we therefore took a constructive stance on equity markets, particularly in Europe and Asia. However, these happy prospects were quickly dissipated by a series of shocks that caused a slump in activity and a leap in inflation:

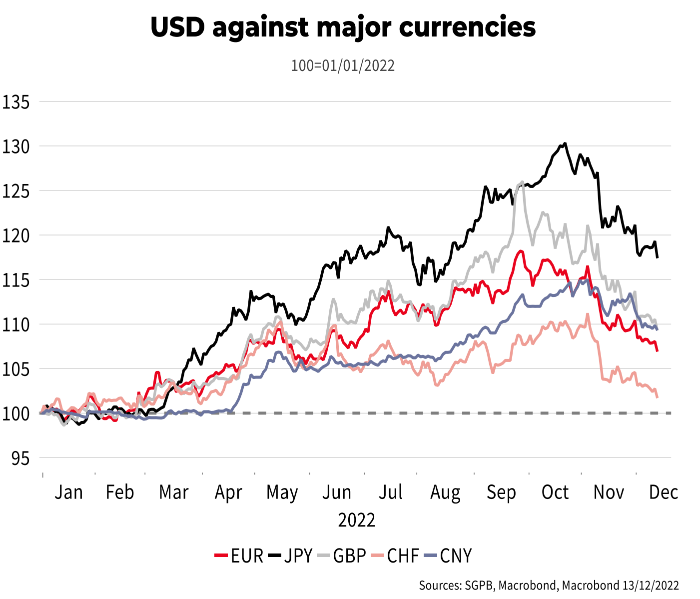
- **Russia's invasion of Ukraine rocked the global economic environment.** European economies were especially hard hit, as confidence plummeted and the energy crisis took hold. Besides its immediate effects, the invasion also disrupted the geopolitical balance of power in ways that may yet have future repercussions for the balance of trade.
- **Stubborn inflation.** The massive commodities price shock meant that inflationary pressures would last longer. Central banks sharply tightened monetary policy. The Fed, ECB and BoE have now hiked rates by 450, 250 and 350 basis points, respectively, and started to trim down their balance sheet assets. These steep rate rises increased the risk of financial instability for heavily indebted economic actors and sectors (such as the United Kingdom).
- **China's maintenance of its zero-Covid policy** and the lack of any comprehensive plan to shore up the property sector resulted in a sharp slowdown in growth.

This affected all major asset classes, which posted deeply negative performances. The main equity indices corrected strongly as economic activity slowed and interest rates rose, pulling the rug from under growth stocks. Emerging equity markets were caught in the backwash from China, affected by slowing activity and rising trade and regulatory risks. Fixed-income markets, meanwhile, had their worst year since the 1980s, with long duration indices being worst hit. In this context, the dollar made big gains against virtually all other currencies thanks to its rate differential, the crisis in dollar-priced energy and the dollar status as a safe haven in risk averse times. The specific circumstances meant that oil was the other asset to perform well on the year.

Taking stock, as we look back to a year ago, the points we called right were basically a strong dollar, equities outperforming bonds, and European stocks outperforming US stocks. In a year when events were as unpredictable as World Cup matches, that's not bad.



Sources: SGPB, Macrobond, MSCI 13/12/2022



Sources: SGPB, Macrobond, Macrobond 13/12/2022

To find our note from last year on the major themes of 2022 (Themes 2022 seen by the Eco&Strat team), please click on this link.

YEAR SHOULD START WELL FOR BONDS

Less growth and gradually less inflation

Our economic scenario for 2023 sees economic activity for developed economies continuing to slow. While some countries may slip into recessions, these should be fairly modest. Support factors such as buoyant labour markets, Covid savings and fiscal measures to counter the energy crisis in Europe should continue to mitigate the negative factors of high inflation, rising interest rates and the European energy crisis. This slowdown should give way to a modest recovery as the year progresses, with growth nonetheless remaining below potential due to the lasting effects of the energy crisis and the need to return fiscal policies to normal. Headline inflation should fall back in 2023 due to base effects. Underlying inflation, however, will take longer to come down, as existing pressures continue to spread out through the economy. Central banks will keep raising rates until 1Q23 and then take a long pause. While markets seem to have priced in much of the tightening to come, there could be further tweaks, notably to central banks' balance sheet policies. In any event, uncertainties are set to remain acute against a backdrop of simultaneous slowdown by leading developed economies and a rapid tightening of interest rates.

Rates to stay high, making bond yields attractive

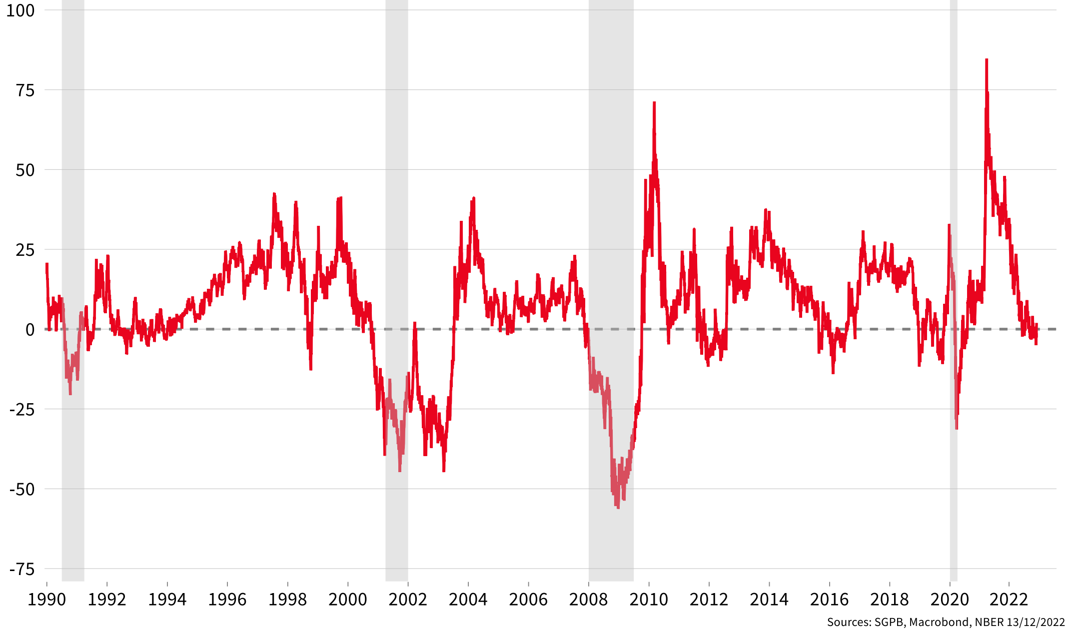
2022 was dominated by the rapid tightening of interest rates, putting an end to years of rock-bottom yields. This automatically drove down bond values. In 2023, markets are likely to remain volatile but should benefit from high rates as long as central banks continue to worry about inflation. Real yields should therefore remain positive and hence attractive, particularly if uncertainty remains high, discouraging investors from taking big risks.

Yield curve could steepen again

For several quarters now, the United States yield curve has been inverted and the inversion got sharper lately. The euro area curve has now followed suit, as bond markets worry about the prospect of a severe recession. Falling long yields basically reflect expectations of a major slump in the economy, triggering a rapid loosening of monetary policy. Under our central scenario, which sees the economy avoiding a deep recession, yields at the long end continue to rise. The continuation or intensification of quantitative tightening policies should also help boost long-term yields. Any such rise would make bond yields yet more tempting. Long yields may ease back again in late 2023/2024 once central banks' inflationary concerns are put to bed.

Gap between the return of equities and the return of bonds

1Y return of the SP500 - 1Y return of the US Treasury index



Sources: SGPB, Macrobond, NBER 13/12/2022

RETURN TO A NEGATIVE CORRELATION BETWEEN EQUITIES AND FIXED-INCOME

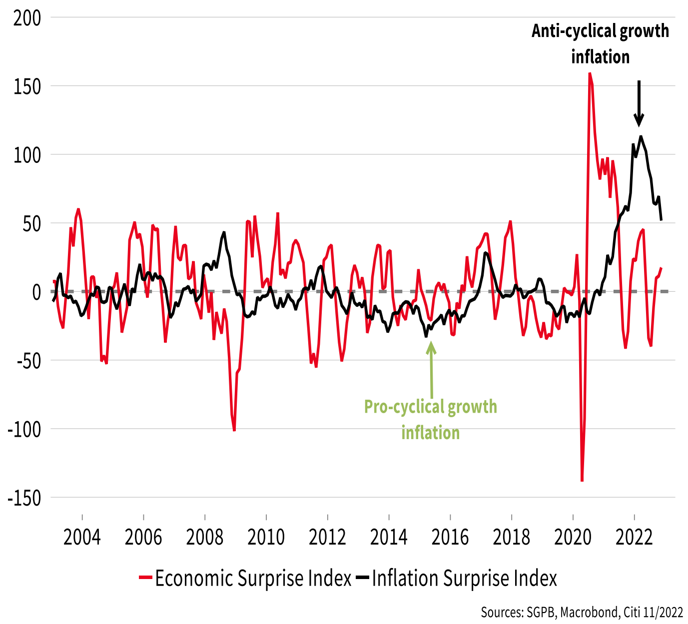
Next year will be good for diversification again

In 2022 bond and equity prices were falling in tandem, creating a clear positive correlation between the two asset classes unseen in more than 20 years. The reason behind this new positive correlation was the particular combination of shocks, which both depressed the economy (bad for equities) and drove up inflation (bad for bonds). Our scenario, under which economic activity continues to slow through 2023 while inflation gradually edges down, in other words a return to growth/inflation procyclicality, would restore the negative correlation between the price of equities and the price of bonds. This negative correlation is what gives diversified portfolios their inbuilt protection at times of stock market volatility. So, the return to a negative correlation makes it easier to diversify risks in an investment portfolio.

After a first half-year favourable to bonds, equities should recover their relative appeal

The year looks set to start amid high uncertainty and ongoing tight monetary policies, a combination that remains good news for bonds. As the year wears on, the environment should tip more in favour of equity markets, once central banks confirm the tightening cycle has peaked and economic growth starts to revive again. Although the recovery remains anaemic, it could still be enough to boost stock markets, where companies are generally sitting on solid balance sheets and resilient nominal growth rates should help sustain healthy margins.

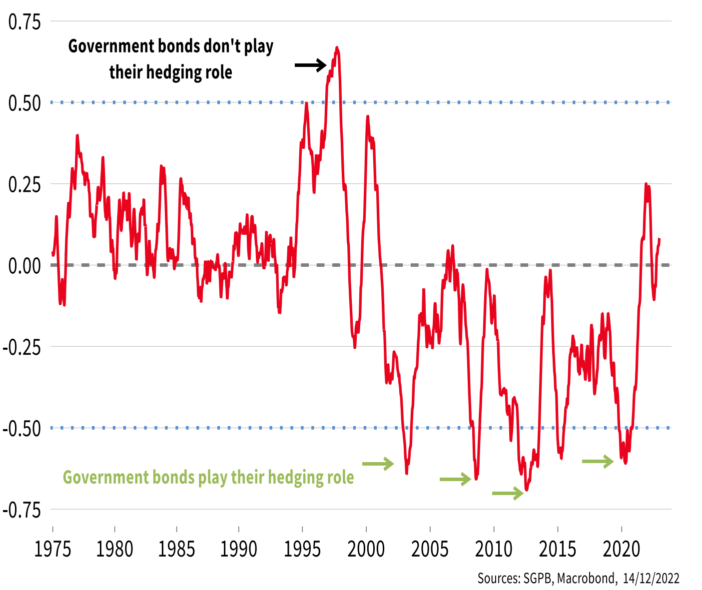
DM: Growth and inflation surprises



Sources: SGPB, Macrobond, Citi 11/2022

Rolling correlation between equity and bond prices

30 day correlation coefficient between the 1 month change of the SP500 and the US Treasury index



Sources: SGPB, Macrobond, 14/12/2022

POSITIVE REAL RATES ARE GOOD FOR DEFENSIVE ASSETS

Central banks aim for positive real rates across the curve

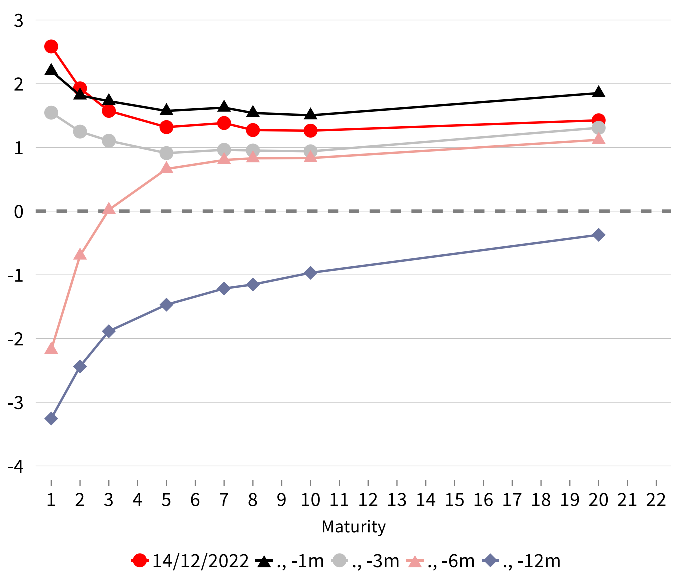
In an environment where the risks of core inflation remain high, central banks are set to keep financing conditions tight in 2023. This should mean real sovereign debt yields remain positive in all maturities. The Fed has already virtually achieved this for longer maturities and by holding its Funds rate at 5% for much of the coming year should ensure short yields turn positive as headline inflation comes down. In the euro area, real yields also rose in 2022, stabilising near zero. The ECB's expected further tightening and announcements of how it plans to run down its bond holdings, coupled with the decline in inflation, should allow European real yields to move more decisively into the positive territory in all maturities.

Defensive assets back in fashion.

This context of positive real yields is a big change from past cycles, including during slowdown phases, and revives the appeal of some assets that have long been side-lined. On debt markets, aside from sovereign bonds, we like investment grade corporate debt. Companies on both shores of the Atlantic are sitting on solid balance sheets, nominal growth is set to hold firm and yields have already adjusted substantially in 2022. On equity markets, we think that, in contrast with the decade of the 2010s, value indices should outperform growth indices, as they are better able to cope with a high-rate environment. In 2022, value indices were boosted by rising commodity prices. Now, the high interest rate environment should support other sectors such as financials and consumer stocks. As a result, and this is particularly true of Europe, we like value indices which are trading cheaply, offer attractive yields and are well placed to ride out the current phase of high rates and weak real activity growth.

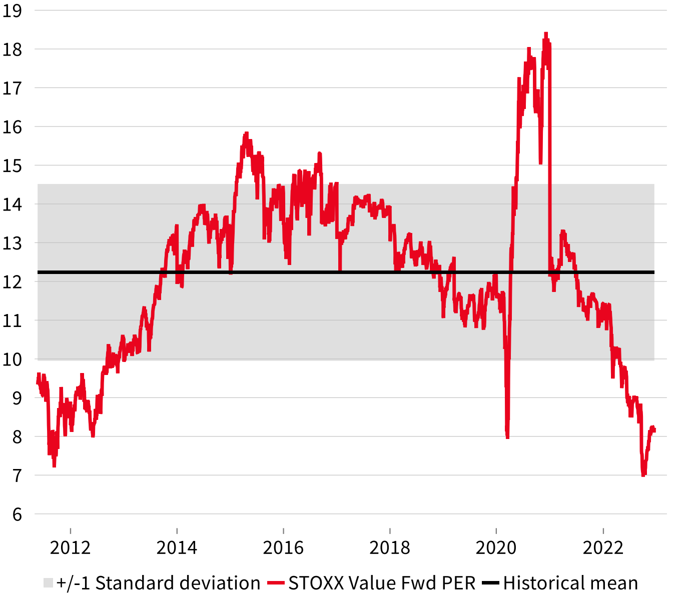
US: Treasury real yield curve

%, nominal yield - inflation breakeven



Sources: SGPB, Macrobon

Europe: STOXX Value PER



Sources: SGPB, Macrobond, 14/12/2022

DOLLAR LIKELY TO SHED SOME OF ITS RECENT GAINS

One of the big stories of 2022 was the sharp rise of the USD against almost all other currencies. This rally reflected the sharp leap in risk aversion in the wake of geopolitical and energy crises, and the widening spread between interest rates paid in the United States and in other leading developed and emerging economies.

In 2023, we expect the dollar to shed some its 2022 gains, depreciating against the euro and other currencies as pro-dollar factors ease or disappear. These include:

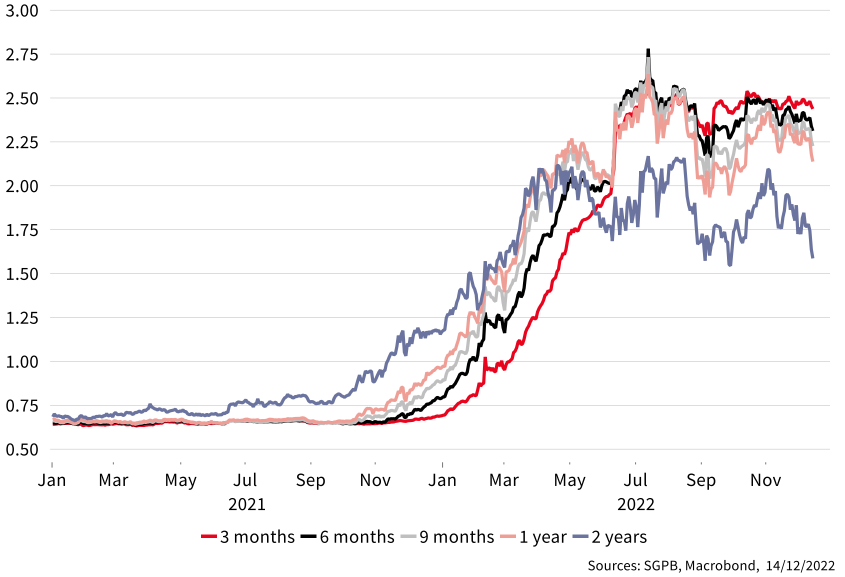
Stabilisation of geopolitical and energy risks. This should support the currencies of energy-importing European and Asian countries. European countries have successfully coped with the near halt of Russian gas supplies and the onset of winter, and this has brought gas and electricity prices down in recent months. A mild autumn and greater use of alternative gas sources meant countries were able to boost their natural gas reserves to all-time highs, reducing the risks of pressure on grids and sudden outages in winter. Europe has thus managed to avoid the worst-case scenario without too severe a hit on the economy for the moment. Also, the weak growth outlook for 2023 should help keep oil prices down. Taken together, these factors should let importer countries stabilise their balances of payments, which worsened sharply in 2022, and this should in turn boost their currencies.

The fall in interest rate spreads between the United States and the rest of the world. The end of the Fed's tightening of monetary policy, probably in Q1 2023, should moderate support for the dollar. In addition, the policy rate spread with other leading central banks should narrow. This should notably be the case with the ECB, where the spread is set to narrow from near 270 bp last August to 225 bp, based on forecast terminal rates of 5% for the Fed and 2.75% for the ECB.

The Chinese economy reopens: The gradual end of the zero-Covid policy should allow China's economy to rebound from the anaemic levels of growth seen in 2022. This should be particularly beneficial to European economies, particularly exporters like Germany, and should further help their trade balances.

Our central scenario is therefore slightly negative for the dollar. However, if the scenario turns out to be less favourable, the dollar could rally once more.

Gap between market expectations of Fed and ECB rates



Sources: SGPB, Macrobond, 14/12/2022

EMERGING MARKETS: ROCKY ROAD TO RECOVERY IN CHINA, MIXED PICTURE ELSEWHERE

Rocky road to recovery in China

After a year blighted by strict adherence to zero-Covid rules and a slump in property investment, China's economy can look forward to a rebound in 2023. On the Covid front, the government has announced an easing of quarantine and health-pass rules, and is seeking to accelerate vaccinations for at-risk groups and the manufacture of treatments. These measures should help perk up domestic demand, although the exit from Covid is likely to be a stop-start affair, as Europe found to its cost. In the property sector, the government is rolling out a support plan which will support developers' finances and allow them to complete projects already under way. As the economy revives with the end of lockdowns, these measures should encourage a pick-up in housing sales and investment during 2023.

Looking beyond the post-Covid rebound, the economy's medium-term prospects remain modest, with growth projections falling well short of pre-2019 levels. First, with an ageing population and already high levels of indebtedness, residential investment looks to have peaked for now. The government is also sticking to its Common Prosperity policy, which seeks to rebalance growth but scales back investment in infrastructure. Between them, property and infrastructure directly or indirectly contribute 40% to GDP.

Mixed picture in other emerging economies

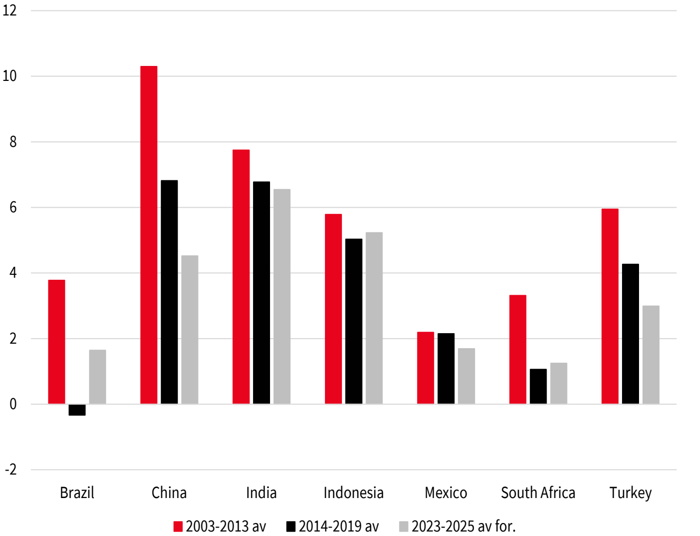
India, Indonesia and wider south-east Asia can look forward to strong economic and financial performances powered by growth-friendly demographics, heavy production of commodities and an influx of investment previously earmarked for China. The Indian stock market has been one of the year's top performers. In Latin America, growth prospects remain grim, particularly for the region's power-houses. Nevertheless, LatAm financial assets were among the best performers in 2022, helped by attractive real-terms carry compared to dollar yields – the region's central banks have been cranking up policy rates since 2021 – their status as major commodity producers and their lower geopolitical risks than other emerging economies. Finally, the emerging economies of Central and Eastern Europe will continue to be shackled by the conflict in neighbouring Ukraine.

In these circumstances, we are taking a cautiously moderate view of these assets. Chinese equities and bonds stand to benefit as China's economy recovers its strength – Chinese assets make up more than 30% of emerging market indices – but any recovery is likely to be volatile as China navigates its reopening policies and trade tensions with the United States. Other emerging financial markets can expect to continue their relatively healthy performances over the year as the Fed (in all likelihood) slows its policy tightening, south-east Asia booms and yields remain relatively attractive.

EM: Main financial indices

Sources: SGPB, Macrobond, MSCI 14/12/2022

Emerging markets: GDP growth



RESIDENTIAL PROPERTY MARKETS HIT BY RATE HIKES

Housing costs remain high
Since Covid, residential property prices have risen substantially in most developed economies, in both nominal and real terms. This price inflation has been driven by previous rock-bottom interest rates, a rise in household savings and greater migration away from big cities toward teleworking in smaller towns.

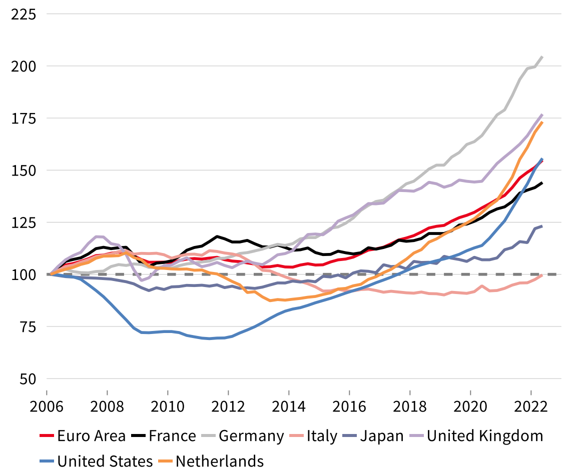
Outlook weakened by the erosion of household purchasing power...
Wages are rarely linked to inflation these days (unlike in the 70s and 80s) which means households feel the full impact of inflation on their budgets and have less to invest in property.

...and higher rates
Mortgage rates have risen fast in the United States and United Kingdom, to their highest since 2013, and are rising in Europe too, albeit more slowly for now as they are more constrained by regulations. In France, banks are likely to rein in new lending, again because of the regulatory framework which sets a cap on the rates they can charge, the usuary rate.

Price decreases are expected to remain broadly contained
The outlook is for prices to fall in the coming months, posing an additional risk to the economic slowdown. It is important to note, however, that most real estate financing is now at fixed rates, including in the US. Thus, while the rise in interest rates will weigh on households' intentions to buy, it should not lead to a deterioration in household balance sheets, limiting the downward potential of property prices. The proportion of variable rates remains significant in certain economies (Canada, Scandinavian and Eastern European economies).

Housing nominal prices

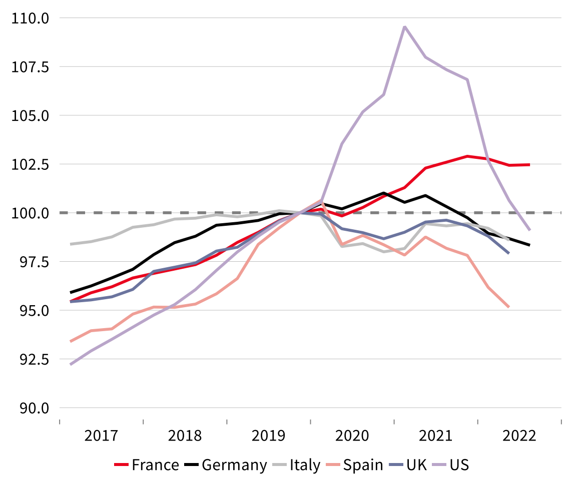
100=2006



Sources: SGPB, Macrobond, BIS 2022 Q2

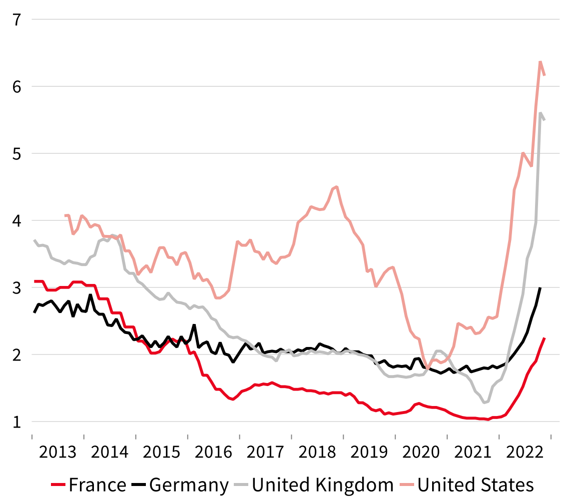
Real households disposable income

100=4Q19



Sources: SGPB, Macrobond, INSEE, DESTATIS, Istat, INE, ONS, CaO, BEA, BUBA, Japanese Statistics B

Mortgage rates



Sources: SGPB, Macrobond, Crédit Logement, BUBA, BoE, FNMA 11/2022

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