M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

25 November 2022

Outlook 2023 (I): dark clouds in the economic sky

As we do every year at this time, we would like to give you an overview of the developments we expect for the economy and the capital markets in the coming year. We will not only communicate our outlook in writing as usual, but also publish it in a new video series from today until shortly before Christmas. Be curious to see what economic developments we expect. Is the sentiment that can be gleaned from the leading economic indicators perhaps worse than the actual situation? And what is inflation doing, whose development this year has had a major impact on both the stock and bond markets? Have inflation rates peaked and how will monetary policy react? Can the euro regain ground or will it remain a weak currency? And last but not least, is there any improvement in sight after the disappointing capital market year of 2022, which saw heavy losses on both the stock and bond markets? We hope you enjoy reading our articles and that you will learn many new and interesting things:

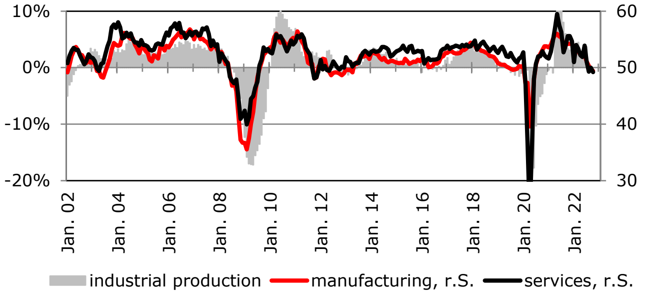
https://www.youtube.com/c/MMWarburgCO

Let's take a brief look back. Economic development in **2022** was significantly weaker than we expected 12 months ago. This year, for example, the global economy is only growing at a rate of around three percent instead of the predicted four percent. There are three main reasons for this development, all of which are closely linked: Firstly, the Russian war of aggression on Ukraine, which began on February 24, has shaken the confidence of companies and consumers in a continuation of the upswing. On the other hand, the war has meant that inflation has not fallen as we had expected. On the contrary, the sharp rise in energy prices, combined with very high food prices, has caused inflation in most countries to reach its highest level in the past 40 years. And third, high inflation has led global central banks to raise interest rates more rapidly and sharply this year than ever before. And this in a phase in which the economy has weakened, in some cases significantly. In the past, monetary policy was then almost always eased, quickly initiating a new economic upswing. Not so this time.

Global outlook 2023: Recession in winter, recovery afterwards

Almost all key global leading indicators have weakened since spring 2022, making a global recession, i.e. a decline in economic activity over at least two quarters, likely. The International Monetary Fund has reduced its global growth forecast several times in succession and now expects the world economy to grow by just under three percent next year. This estimate may still be a little too optimistic, as the economy has lost considerable momentum, particularly in the industrialized countries, but also in some emerging markets, so that the economic downturn will accelerate in the winter months. From today's perspective, however, there is much to suggest that the global economy will regain its footing and return to growth from the spring onwards. This is because there is no evidence that major economic imbalances have arisen in recent quarters that would need to be corrected over a longer period. Household debt has remained comparatively low, and unnecessary capacity has not been built up, perhaps because a lack of intermediate goods and disrupted supply chains prevented this during the Corona pandemic. The further course of the Corona pandemic, on the other hand, remains a difficult "wild card" for the global economy to forecast, although the progress in vaccination that has now been achieved should ensure that we are spared a new and threatening wave of infection. However, possible new virus mutations could shake up this positive assessment. From today's perspective, it is equally uncertain how the war in Ukraine will develop. Hopes are based on the assumption that peace negotiations will be held next year and that the war will end. However, in view of the very different, not to say irreconcilable positions held by Kiev and Moscow, these hopes seem rather deceptive at the moment.

Global Purchasing Managers indices and OECD industrial production (y/y)

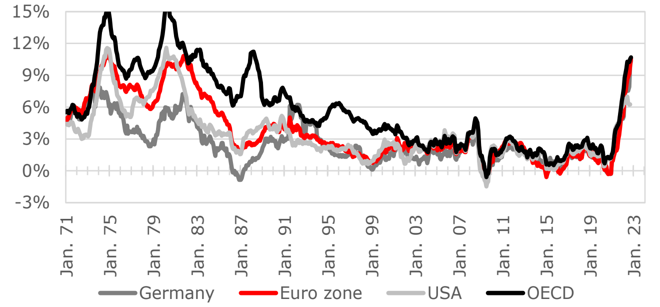


source: Refinitiv Datastream

Inflation: Peak almost reached, stronger decline only later in the year

As last year, inflation was the biggest surprise this year. Instead of the decline we had expected over the course of the year, prices rose at an increasingly rapid pace. While initially only energy prices were responsible for the price pressure, prices are currently rising significantly for almost all goods and services in the basket. However, there are increasing signs that inflationary pressure is easing. In the USA in particular, inflation is likely to have peaked, but in Europe the delayed effects of higher energy prices mean that there is still no sign of any significant improvement in consumer prices until the spring of next year. It is only then that the effects of the economic downturn, which is leading to falling raw material, transport and goods prices, in conjunction with the electricity and gas price brakes, are likely to be felt in Europe.

World: inflation rates



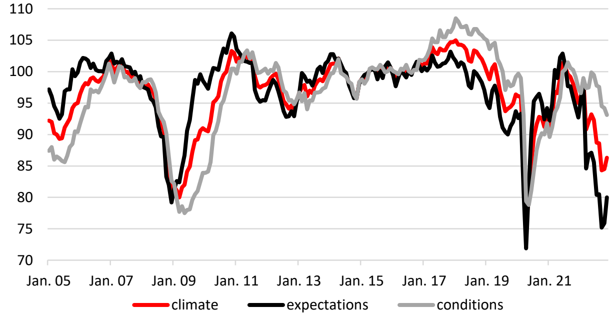
source: Refinitiv Datastream

While the decline in inflation rates is now quite clear, the question of how fast inflation will fall is much more difficult to assess. The very low unemployment observed in many countries increases the risk of wage-price spirals or at least high wage settlements, which companies will try to pass on to prices. While demand for goods could slowly subside, demand for services is still very robust, so inflation will remain comparatively high in the first half of the year. Only in the second half of the year base effects and the economic slowdown are likely to have a stronger impact on prices. By the end of the year, a significant decline in inflation should therefore be possible, although it is highly unlikely that the two percent mark will be reached in 2023, either in the USA or in the countries of the euro zone.

Germany: Sentiment worse than the situation?

A look at the sentiment indicators in Germany underlines the fact that the economic outlook has deteriorated significantly. For example, the ifo business climate index has virtually plummeted in recent months, with the expectations component in particular - i.e. the economic assessment for the next six months - falling to a very low level. Even if pessimism about the coming months has eased recently, the list of factors weighing on the German economy remains quite long: As in other economies, persistently high inflation rates are leading to a noticeable loss of purchasing power among private households. Although it has so far been possible to cushion the real loss of income and wealth through high savings, the drop in the savings rate to pre-Corona levels signals that consumers' financial reserves will soon be depleted. As long as the inflation rate does not fall significantly, consumers will continue to be reluctant to spend, especially on durable consumer goods such as electrical appliances or furniture, and on vacation planning. We therefore expect private consumption to decline by 0.2 percent in 2023.

ifo business climate index



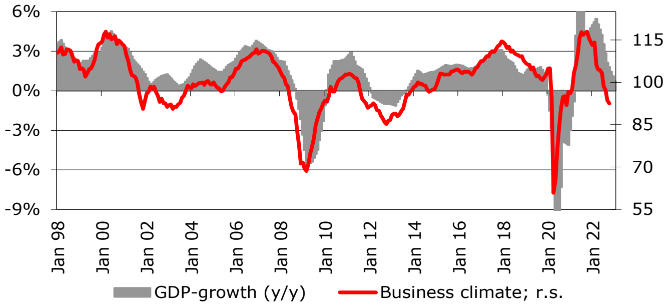
Source: Refinitiv Datastream

But the headwinds are also getting stronger for industrial companies. The increasing reluctance of companies to invest is reflected in the recent decline in order intake, although the order backlog is still very high. At the same time, rising production costs and more difficult refinancing conditions triggered by the ECB's turnaround on interest rates are putting the profitability of many companies to a severe test. For these reasons, capital expenditure is expected to decline by 1.1 percent in the coming year. Furthermore, the German economy is particularly hard hit by the global economic slowdown due to its high dependence on exports. The focus is particularly on economic growth in China, which has been repeatedly held back by the Chinese leadership's strict corona zero tolerance policy to date. We expect exports to decline by 0.9 percent in 2023. However, the construction industry is also facing challenging times: high material costs and shortages, significantly higher mortgage interest rates and labor shortages are leading to increasing restraint in private residential construction. This development can be seen from declining building permits for apartments.

We therefore expect negative growth for the German economy as a whole in the winter months and spring. However, we do not expect a prolonged and severe recession and expect an economic recovery in the second half of the year. In addition, inflationary pressure in Germany is likely to ease from spring 2023, stabilizing the financial situation of many consumers and thus supporting consumption. Further relief for private households will come from government support measures such as the gas and electricity price brakes, which will cap energy prices for a basic quota from January 2023. In addition, companies have well-filled order books and can therefore maintain their capacity utilization even in the event of a temporary decline in orders. And last but not least, the supply chain problems and the strict corona zero tolerance policy in China should move further into the background in the second half of 2023, so that the economic outlook brightens again. For the year as a whole, we expect GDP in Germany to decline by 0.6 percent.

Eurozone: Monetary policy a burden

E-19: Business climate and GDP-growth



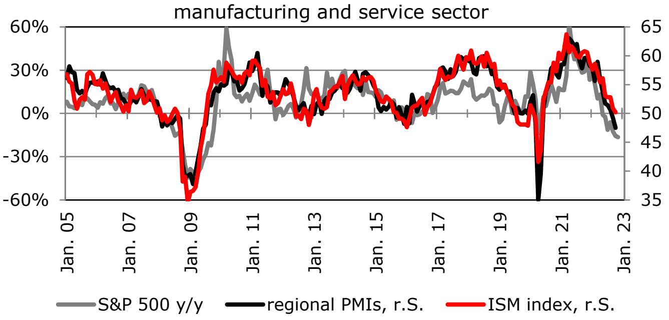
source: Refinitiv Datastream

We expect a similar economic trend for the euro zone. While economic growth in 2022 was still characterized by positive catch-up effects and a high propensity to consume within the tourism sector, the economy will weaken in the following months. The economic downturn will be exacerbated by the restrictive monetary policy of the European Central Bank, which will extend well into 2023 and will have a negative impact on many companies' willingness to invest due to tighter refinancing conditions. However, the still robust labor market is an important pillar for the economy in the euro zone. Although the unemployment rate will rise somewhat in the coming months, the current rate is at a historic low, so the negative effects on employment levels and consumption will be relatively mild. In 2023, real economic output in the euro zone is expected to fall by 0.2 percent. While Germany will suffer greater economic losses than other euro zone countries, the economies of countries that are less dependent on exports, such as Spain and Italy, are likely to record slightly positive economic growth in 2023 due to the statistical overhang from this year.

USA: In better shape than Europe, but short recession likely

The economic situation in the USA is more robust than in the euro zone. This is mainly due to the fact that energy prices have risen far less sharply this year and the country has sufficient oil and gas reserves of its own. An energy tightening, which cannot be ruled out in Europe, is therefore not an issue for the USA. Nevertheless, the leading indicators also point to an imminent recession in the United States, but this is likely to be short and relatively harmless. This is at least indicated by the purchasing managers' indices, which have so far held up better than in other industrialized countries. Only the inverse yield curve, i.e. the yield gap between ten-year and two-year government bonds, is so far an indication that the USA could also face a deeper recession in 2023.

USA: Purchasing managers indices from the manufacturing and service sector

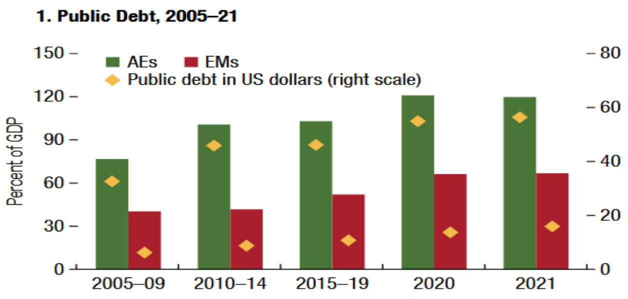


sourcee: Refinitiv Datastream

The most obvious signs of weakness are currently coming from the housing market. The sharp rise in mortgage interest rates, which have more than doubled since the beginning of the year from a good three percent to around seven percent, has led to a marked reluctance to buy private real estate. Lower real estate sales normally also have a negative impact on private consumption, as less money is spent on furniture, kitchens and other furnishings, for example. However, private consumption is also likely to weaken in the coming months due to the negative income trend. Although hourly wages have risen strongly, they have not kept pace with inflation. Negative real incomes have so far been offset by the fact that many private households built up high savings during the pandemic and have recently been gradually liquidating them. In the meantime, however, the U.S. savings rate is again below the long-term average, which has prompted many Americans to take out more loans. The debt situation is still unproblematic, but expensive credit card loans in particular have risen sharply recently. As this pace is unlikely to be sustained, the momentum of private consumption should slacken and thus also slow down the US economy. The extent to which consumption will slow will depend above all on further developments on the US labor market. The interest rate hikes by the US Federal Reserve have so far had little effect, and the unemployment rate remains extremely low. The Federal Reserve is therefore likely to tighten its monetary policy further, with the result that the unemployment rate is likely to rise in the further course of the year. This should slow both income growth and consumer spending.

As inventories at many companies have risen significantly in recent months, industrial production is likely to be cut back in 2023. As this will lead to lower capacity utilization, significantly less expansion investment is to be expected. This will also mean that the US economy will hardly grow on average next year. We expect the rate of real GDP growth to slow from around two percent this year to around 0.5 percent next year.

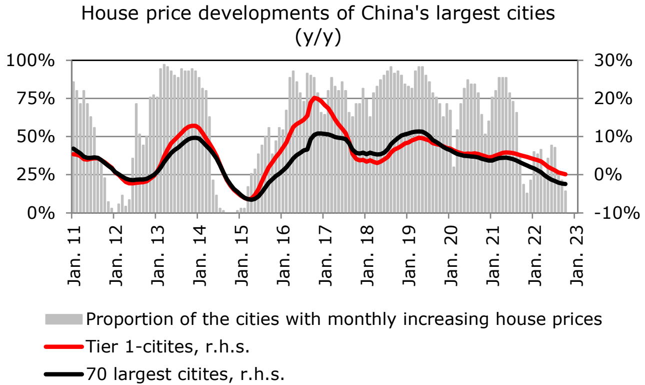
Emerging markets: Is debt becoming a problem?



source: IMF World Economic Outlook, April 2022, p. 42

Historically high debt levels and rising interest rates negatively affect the economic outlook for the emerging markets. Not only in industrialized countries, but also in developing countries, public debt has risen sharply in the wake of the Corona pandemic due to fiscal packages for companies and private households. According to the International Monetary Fund, the average ratio of public debt to GDP in emerging markets was at a record 67 percent in 2021, up from about 52 percent before the pandemic. Due to rising interest rates and the strong appreciation of the U.S. dollar, refinancing risks in emerging markets are increasing significantly: first, the average maturity profile of public debt in emerging markets is shorter compared to advanced economies, and second, the share of public debt denominated in foreign currencies (mainly in U.S. dollars) has continued to rise in recent years. As a result, in October the International Monetary Fund revised its growth forecast for emerging markets downward to 3.7 percent for 2023. At the upper end of the growth forecasts is India, with expected economic growth of 6.1 percent. At the lower end, the International Monetary Fund ranks Russia with a forecast GDP decline of 2.3 percent.

While almost all central banks worldwide are combating the historically high inflation rates with tight key interest rate increases, the Chinese central bank is looking at a contrary development of consumer prices in **China**. With a comparatively low inflation rate of around two percent in 2022, the People's Bank of China continues to have monetary policy leeway to cushion the economic slump and, in particular, to support the ailing real estate market with further key interest rate cuts.



Quelle: Refinitiv Datastream

Also with regard to the handling of the Corona virus, China behaves differently than most of the rest of the world. With its strict zero-tolerance Corona policy, the Chinese government has repeatedly caused a temporary economic standstill in the affected cities and regions, which has had a severe impact on the domestic economy and the economies of its trading partners. Although the first steps toward easing the policy have recently been announced, it is difficult at this point in time to assess how these steps will be implemented in practice and when the Chinese government will be able to intervene in public life and the economy with a sufficiently high degree of certainty. China will fall well short of its self-imposed growth target of 5.5 percent in 2022 and will only achieve real GDP growth of around three percent. Looking ahead, China is thus losing further ground as a global growth engine. On the one hand, the Corona zero tolerance policy remains the great sword of doom, and on the other, the cooling global economy is weighing on foreign trade in the Middle Kingdom. But the fact that Chinese President Xi Jinping cemented his power at the Communist Party Congress in October and only included loyal henchmen and not reformers or proven economic experts in the closest leadership circle is also not good news for the medium- to long-term growth prospects. In 2023, we expect real GDP to increase by just under four percent. However, if the Chinese party leadership quickly turns away from its Corona zero-tolerance policy, a noticeable acceleration in growth can be expected.

Market data

	As of	Change versus				
	25.11.2022	18.11.2022	24.10.2022	24.08.2022	24.11.2021	31.12.2021
Stock marktes	09:16	-1 week	-1 month	-3 months	-1 year	YTD
Dow Jones	34194	1,3%	8,6%	3,7%	-4,5%	-5,9%
S&P 500	4042	1,9%	6,4%	-2,4%	-14,0%	-15,2%
Nasdaq	11285	1,2%	3,0%	-9,2%	-28,8%	-27,9%
DAX	14540	0,7%	12,4%	10,0%	-8,4%	-8,5%
MDAX	26034	1,1%	12,0%	-0,1%	-25,2%	-25,9%
TecDAX	3125	0,8%	12,7%	2,9%	-18,3%	-20,3%
EuroStoxx 50	3963	1,0%	12,3%	8,1%	-7,3%	-7,8%
Stoxx 50	3764	1,5%	9,0%	3,2%	0,7%	-1,4%
SMI (Swiss Market Index)	11158	1,0%	5,3%	1,3%	-10,0%	-13,3%
Nikkei 225	28283	1,4%	4,8%	-0,1%	-3,5%	-1,8%
Brasilien BOVESPA	111831	2,7%	-3,6%	-0,9%	7,0%	6,7%
Russland RTS	1146	-0,1%	7,8%	-3,1%	-31,0%	-28,2%
Indien BSE 30	62239	0,9%	4,0%	5,3%	6,7%	6,8%
China CSI 300	3776	-0,7%	3,9%	-7,5%	-23,2%	-23,6%
MSCI Welt	2706	1,8%	8,5%	-1,1%	-15,4%	-16,3%
MSCI Emerging Markets	946	0,3%	12,2%	-4,0%	-24,5%	-23,2%
Bond markets						
Bund-Future	142,14	196	598	-812	-2840	-2923
Bobl-Future	120,08	21	132	-437	-1497	-1316
Schatz-Future	106,75	-9	1	-240	-567	-528
3 Monats Euribor	1,90	50	124	198	248	249
3M Euribor Future, Dec 2017	2,19	2	-6	0	277	3
3 Monats $ Libor	4,76	9	43	175	458	455
Fed Funds Future, Dec 2017	4,13	-1	-6	0	405	3
10 year US Treasuries	3,66	-17	-57	55	201	216
10 year Bunds	1,87	-15	-47	57	210	205
10 year JGB	0,25	1	0	3	17	18
10 year Swiss Government	0,98	-7	-33	15	112	112
US Treas 10Y Performance	585,64	1,0%	4,8%	-3,9%	-14,6%	-16,2%
Bund 10Y Performance	557,99	1,5%	4,7%	-3,9%	-16,1%	-15,8%
REX Performance Index	441,00	1,0%	1,8%	-3,5%	-10,6%	-10,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	3,04	-16	-62	57	263	256
IBOXX BBB, €	4,19	-24	-86	58	335	332
ML US High Yield	8,69	-19	-74	65	368	379
Convertible Bonds, Exane 25	6705	0,0%	5,9%	-0,8%	-19,1%	-18,1%
Commodities						
MG Base Metal Index	396,34	-0,8%	7,4%	-0,5%	-13,2%	-14,1%
Crude oil Brent	86,04	-1,8%	-7,8%	-15,1%	4,5%	9,7%
Gold	1752,29	-0,1%	6,3%	-0,1%	-1,8%	-3,8%
Silver	21,29	1,1%	10,7%	11,3%	-9,4%	-8,5%
Aluminium	2337,76	-2,8%	8,4%	-4,2%	-13,7%	-16,7%
Copper	8003,00	-0,5%	4,1%	-0,7%	-19,1%	-17,8%
Iron ore	91,94	-1,0%	-2,7%	-12,9%	-2,5%	-18,3%
Freight rates Baltic Dry Index	1242	4,5%	-30,9%	2,4%	-53,2%	-44,0%
Currencies						
EUR/ USD	1,0417	0,5%	5,7%	4,9%	-7,0%	-8,0%
EUR/ GBP	0,8606	-0,9%	-1,5%	1,8%	2,5%	2,5%
EUR/ JPY	144,42	-0,5%	-1,6%	6,4%	11,9%	10,8%
EUR/ CHF	0,9829	-0,5%	-0,3%	2,6%	-6,2%	-4,9%
USD/ CNY	7,1614	0,6%	-1,4%	4,4%	12,0%	12,7%
USD/ JPY	138,63	-1,2%	-6,9%	1,1%	20,1%	20,4%
USD/ GBP	0,83	-1,4%	-6,5%	-2,3%	10,2%	11,9%

Source: Refinitiv Datastream

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