



15 December 2023

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Macroeconomic outlook:
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Capital markets outlook: Rates struggle
between policy pivot and supply

Allianz Research

Looking back, looking forward

Global Economic Outlook 2023-25



Our holiday playlist
inspired by Taylor Swift

Executive Summary

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Since our last quarterly economic update in September, growth momentum has been weakening but remained resilient, disinflation is ongoing and interest rates are plateauing, very much in line with our expectations. To build on our September outlook, [The last hike?](#), we updated our forecasts and sharpened our investment calls for 2024 with a twist. Looking back, “there’s no question that 2023 belongs to Taylor Swift” as Forbes put it.¹ Looking forward, we decided to take Swiftonomics to 2024 just because: Taylor rules! (yes, pun intended). While we identified ten key topics that you should keep your eyes and ears open to in 2024, we matched each and every one of them with a hit song by Ms Swift, and created a [holiday playlist](#) for you. Disclaimer: the rest of this report is serious stuff. Happy holidays from the Swifties at Allianz Research!

... Ready for it? - 2024 will be a crowded political year. European voters will elect their EU representatives; Portuguese, Belgian, Austrian, Indian, Mexican and UK voters will elect their MPs while the US, Mexico, Taiwan and Romania will also choose new presidents. Amid rising populism, and with a lot of uncertain ballots, households and firms are likely to adopt a wait-and-see approach and postpone key economic decisions from large purchases to major investments.

Is it over now? - We expect a soft landing in the US and the Eurozone to muddle through, with increasing risks of a prolonged recession in H1 2024 for the Old Continent as only 60% of the increase in key policy rates has been transmitted to borrowers in Europe. We forecast 2024 GDP growth at +1.4% in the US, +0.8% in the Eurozone, +4.6% in China and +0.6% in the UK.

Shake it off - Thanks to softening demand and positive base effects on energy and food, disinflation is gaining traction. We anticipate that central banks will pivot earlier than expected by economic forecasters (i.e. summer 2024) but later than market expectations as it takes time to cool down a hot labor market. Indeed, services inflation and wage growth continue to fuel inflationary pressures, especially in the US. By end-2024, we expect policy rates to stand at 4.5% in the US, 3.5% in the Eurozone and 4.5% in the UK.

You’re on your own kid - Fiscal safety nets are unwinding in Europe as most countries have committed to moderately reign in fiscal deficits. The German government managed a last-minute budget agreement, but we do not expect a major boost to economic activity from the deal. However, in the US, fiscal consolidation remains more talk than walk for now.

¹ 9 Times Taylor Swift Crushed 2023 ([forbes.com](https://www.forbes.com)).

Out of the woods - Global trade is set to rebound modestly after two consecutive years of below-average global GDP growth. As European countries are emerging from trade recessions and Asian countries (ex-China) are still benefiting from the reshuffle in global value chains, they will lead the rebound. Moreover, destocking in the global business cycle should come to an end in 2024, also contributing to the rebound.

Anti-hero - Earlier this year there were high hopes that Chinese consumers would reignite the global economy, but they did not save the day. China is still grappling with a distressed property market and consumer confidence remains muted. To offset some of its losses in global export markets and soft domestic demand, China has increased and will maintain policy support, while also increasing investment abroad to consolidate its influence.

Everything has changed - Most emerging markets managed to successfully curb inflation while battling higher financing costs and sometimes tense social backdrops. Managing the descent in rates, a weaker dollar and lower twin deficits while benefiting from friend-shoring should be prove easier. But it will not be a walk in the park as policy mistakes could derail previous success. Countries such as Egypt, Argentina and Ghana will continue to face major hurdles due to large amounts of debt that need to be refinanced at a high cost.

I knew you were trouble - Corporates have managed to navigate the higher yield environment quite successfully so far. However, insolvencies are picking up in most countries, suggesting the large divide between SMEs that are facing liquidity and profitability issues and larger firms that remain resilient. Going forward, rising rates should continue to bite profitability and liquidity, while revenue growth should soften. Some sectors such as real estate, renewable energy and construction are in the midst of the storm, with high leverage, depreciating assets and large financing needs for both opex and capex.

Bad blood - In 2024, long-term interest rates are unlikely to decrease significantly as policy cuts are already priced in and the supply factor will maintain upside pressures. Equities in advanced economies are expected to yield returns close to 5% amid increased volatility. Corporate credit spreads have shown resilience, indicating market confidence in a soft landing. While the overall outlook is cautiously optimistic, watch out for potential risks in specific market segments (i.e. commercial real estate, energy etc.).

Delicate – Despite a challenging environment and some financial cracks under the surface revealed by the short-lived banking crisis in the US, markets have been dismissive of mounting liquidity pressures. We expect the liquidity squeeze to intensify and add pressure on corporate spreads. However, the risks do not seem systemic as some buffers remain on both the corporate and policymaker sides.



Macroeconomic Outlook

A crowded political year

Geopolitical and economic policy uncertainty will act like a negative supply shock in 2024. After a series of shocks in recent years – from the pandemic to the energy crisis – the packed election calendar in 2024 will add to economic uncertainty as countries that account for 60% of global GDP head to the polls. In this context, governments, households and companies are likely to adopt a wait-and-see approach, postponing key economic decisions. Fiscal uncertainty is particularly high for Germany, while it is also rising in China and the UK. Shocks related to policy uncertainty can have a material impact on activity and prices, acting like negative supply shocks: raising prices while lowering output, investment and consumption. A one standard deviation increase in fiscal policy uncertainty from government spending is associated with a statistically significant drop in real GDP by -1pp after two years.² Monetary policy uncertainty follows a similar dynamic, being

associated with a decrease in real GDP by -1.3pp after two years. Given the current environment of high inflation and rising global recession risks, policymakers must make every effort to minimize the uncertainty about their future decisions.

Populism is at an all-time high, with more than 25% of nations governed by populist leaders. After 15 years, GDP per capita in countries run by populist leaders is 10% lower on average compared to that of a country run by a non-populist government.³ Moreover, populist rule often leads to a decline in judicial independence, election quality and press freedom, while also damaging the innovation-friendly economic environment. In Europe, rising inflation and increased immigration have fueled a resurgence of right-wing populism and there are concerns that the next European Parliament could be dominated by anti-environment and anti-immigration voices, hindering progress on crucial matters like institutional reform and energy security.

² Haroon Mumtaz and Franz Ruch (2023). Policy Uncertainty and Aggregate Fluctuations Evidence from Emerging and Developed Economies, World Bank Policy Research Working Paper 10564.

³ Manuel Funke, Moritz Schularick, and Christoph Trebesch (2023). Populist Leaders and the Economy. American Economic Review, In press.

Elections that take place in a polarized context can lead to higher economic uncertainty, but high uncertainty can also lead to more polarized and populist outcomes in elections as well. On average, economic policy uncertainty is 13% higher in the month before and the month of national elections compared to other months.⁴ In the US, economic policy uncertainty increases are especially pronounced around close and highly polarized presidential elections (+28% in the same month). This pattern also suggests larger spikes in uncertainty around future elections in other countries around the world that have experienced rising polarization in recent years.

Figure 1: Upcoming elections



Source: Allianz Research

⁴ Scott Baker, Aniket Baksy, Nicholas Bloom, Steven Davis, and Jonathan Rodden (2020). Elections, Political Polarization, and Economic Uncertainty, NBER Working Paper 27961.

Soft landing in the US, muddling through in the Eurozone

With the US economy defying gravity in 2023, a soft-landing scenario is strengthened for 2024. US GDP will have grown by about +2.4% in 2023 despite the Federal Reserve's sharp monetary tightening. Households and corporates have built solid balance sheets overall by lengthening the maturity structures of their debt prior to the Fed tightening and by locking in low fixed interest rates. Debt-servicing costs make up less than 10% of US household income at the end of 2023, the lowest level in recent history. Moreover, US households have continued to dig into their pandemic savings to sustain solid consumption spending. Meanwhile, fiscal policy has been loose: Social Security payments have increased by +12% in 2023 (much higher than inflation) while the effective personal tax rates have dropped by -1.7pps between end-2022 and end-2023 – the sharpest drop seen during any Fed tightening episode since at least 1972. However, for 2024, we continue to expect a rapid deceleration of growth, with a weak spot (around 0% growth) expected in Q2 and Q3. The high interest rate environment is starting to weaken some segments of the economy. Consumer loan delinquencies have started to pick up, while cyclical hiring (e.g. in retail) is losing momentum. Meanwhile, some of the factors that boosted 2023 growth should reverse, such as tighter (though not overwhelming) fiscal policy. At the corporate level, prolonged tight lending standards from banks should lead to a weakening of business investment – already evidenced in low capex intentions. We also expect households to slow their usage of pandemic savings – which are still far from being exhausted yet (we estimate them at USD1,000bn in Q3 2023) – to fund consumption expenditures: data indicate that households have been increasingly shifting their funds from liquid deposits to less liquid time deposits and money market funds since summer 2023. Against this backdrop, solid private sector balance sheets, falling inflation and an improvement of the supply side of the economy (through a boost to labor supply and a pick-up in productivity) should allow the US economy to head towards a soft landing in 2024, with GDP expected to rise by a decent +1.4% over the year.

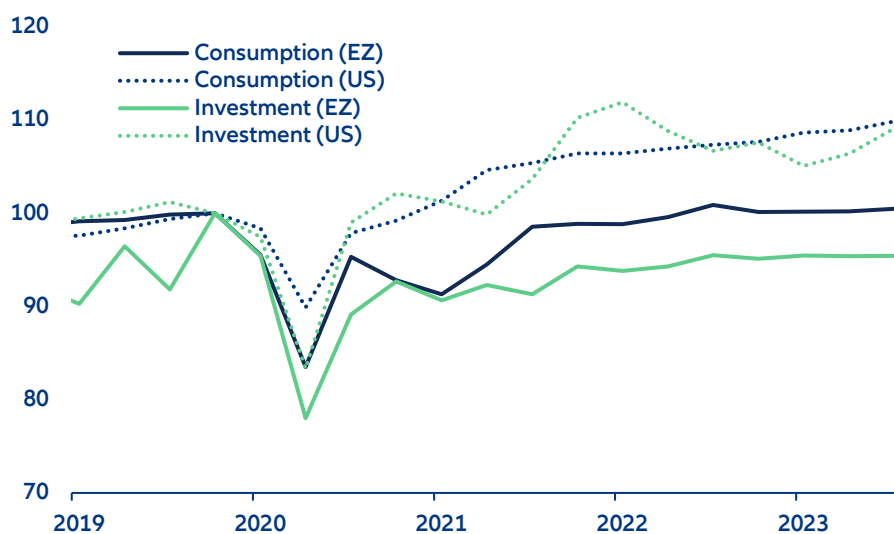
After an extended period of economic stagnation, the Eurozone should rebound in the second half of next year as past headwinds recede. The Eurozone has grappled with near-zero growth for four quarters and the near-term outlook does not change that picture. In fact, we see a small technical recession due to another negative growth print in Q4 after -0.1% q/q in Q3 2023. However, we are cautiously optimistic that the Eurozone can emerge from this period of stagnation in the second half of 2024, with growth anticipated to pick up as several economic challenges begin to recede. Firstly, aggressive monetary tightening is expected to moderate, which will ease financial conditions. Secondly, the energy crisis, a significant impediment to the manufacturing sector due to high electricity prices, is showing signs of relief. Though prices remain elevated compared to what they were before the war in Ukraine, any further global price decreases will alleviate pressures – as we see currently with Brent prices down by -USD20/bbl since September. Moreover, the Eurozone is dealing with depressed real wages, still trailing behind pre-Covid levels, which has stifled consumer spending. These trends have left the Eurozone far behind the US in terms of economic activity. Fortunately, there are indicators of a turnaround. Nominal wage growth, coupled with subsiding inflation, is expected to bolster real wages, potentially reinvigorating consumer demand. Lastly, the region is poised to experience a negative output gap, suggesting that without a recalibration of potential growth – which is not presently expected – economic activity is likely to rebound mechanically, barring unforeseen shocks. This automatic adjustment promises some degree of recovery, laying the groundwork for a pick-up in Eurozone economic activity in the medium run.

Table 1: GDP growth forecast

Growth (yearly %)	2021	2022	2023f	2024f	2025f
Global	6.2	3.0	2.7	2.4	2.8
USA	5.8	1.9	2.4	1.4	1.9
Latin America	7.1	3.9	2.3	1.7	2.3
Brazil	5.3	3.0	3.1	1.5	1.9
UK	8.7	4.4	0.5	0.6	1.5
Eurozone	5.9	3.4	0.5	0.8	1.7
Germany	3.1	1.9	-0.3	0.5	1.7
France	6.4	2.5	0.8	0.7	1.5
Italy	8.3	3.9	0.7	0.6	1.5
Spain	6.4	5.8	2.4	1.5	1.8
Central and Eastern Europe	6.1	0.8	0.9	2.3	3.1
Poland	6.9	5.1	0.5	2.5	3.0
Russia	5.6	-2.1	3.1	1.6	1.5
Türkiye	11.4	5.5	3.9	2.9	3.9
Asia-Pacific	6.4	3.2	4.4	4.0	3.9
China	8.5	3.0	5.2	4.6	4.2
Japan	2.3	1.0	1.8	1.0	1.0
India	8.9	6.7	6.9	6.3	6.5
Middle East	4.4	6.7	2.3	2.3	3.1
Saudi Arabia	4.3	8.7	1.4	1.8	4.2
Africa	5.8	3.8	2.7	3.4	4.1
South Africa	4.7	1.9	0.7	1.4	1.6

Sources: LSEG Datastream, Allianz Research

Figure 2: Consumption and investment remain depressed in the Eurozone, Index 2019 = 100



Sources: LSEG Datastream, Allianz Research

What could go wrong? A deeper recession in the Eurozone economy, economic contagion from a collapsing commercial real estate market or escalating geopolitical risk cannot be ruled out. There is a plethora of risks out there as the world is still recovering from a global health and energy shock that drove inflation to multi-decade highs. The journey back to equilibrium is naturally paved with uncertainties. Despite a resilient labor market, leading indicators such as bank lending and economic sentiment are pointing to a more pronounced recession on both sides of the Atlantic. In Germany and France, electricity prices are still three times as high as in the US compared to almost parity before the Ukraine-Russia conflict. This could put more strain on the energy-intensive manufacturing sector in Europe, leading to a more pronounced economic slowdown, at a time when governments will drastically reduce their energy subsidies. Furthermore, the potential contagion from a tumbling commercial real estate market cannot be ignored, with Austria's largest private real estate holding, Signa group, being the latest victim. Moreover, in a world with multiple ongoing conflicts, the risk of escalation is a persistent threat. We see these risks and observe them closely, but they remain a downside scenario and not our baseline. However, if these risks materialize and lead to a systemic contagion, 2024 could turn out to be much weaker than currently anticipated. In such a downside scenario, we would see a recession materializing, a correction in the stock market, an even stronger USD and significantly more rate cuts down the road.

Disinflation is gaining traction and central bank pivot in summer 2024

The pace of disinflation has accelerated: inflation should be within most central banks' comfort zones by the summer of 2024. The rapid unwinding of supply-chain tensions and lower commodity prices have pushed down inflation more rapidly than expected towards the end of 2023. Core goods inflation has already completely normalized in the US since September, while it is decelerating rapidly in the Eurozone. Encouragingly, stickier services inflation has also started to turn down amid softer wage growth, though it remains elevated. The hawkishness of central banks – both in words and actions – has decisively helped to avoid a wage-price spiral from taking off by weakening demand (or avoiding over-heating in the US) and keeping inflation expectations generally well anchored. We expect inflation rates to continue to normalize – as indicated by businesses' lower selling-price expectations in surveys, as well as falling production prices. Headline and core inflation should approach central bank's targets by next summer in major economic regions (the UK being the

relative laggard) amid lower growth as well as lower goods and energy inflation feeding into gradually lower services inflation.

The resilience of labor markets, especially in Europe, has been remarkable despite low growth. Structural shortages are here to stay. Despite lackluster growth in Europe over the past 12 months, unemployment rates have remained at rock-bottom lows and vacancies at historically high levels. In some countries (France, Spain, UK), this is partly the reflection of a drop in the efficiency of labor. However, more generally, the pick-up in labor supply and depressed real wages (the cost of labor from a corporate standpoint) have incentivized companies to hire more workers. With labor shortages expected to worsen in the coming years – amid deteriorating demographics – and demand to remain resilient (because of the green transition, re-shoring, healthcare needs etc.), labor markets should remain tight. In the short-term horizon, we expect only a modest rise in

unemployment in the US and Europe for 2024 despite weak growth as corporates are reluctant to shed workers.

Central banks will pivot in summer 2024 but maintain a hawkish bias as they do not want to be caught twice in calling inflation wrong. With inflation at arms-length of central bank targets and subdued growth, we expect the Fed to start the easing cycle in June 2024, with an initial rate cut of 25bps, followed by the ECB in July and the BoE in September. However, adopting a ,once bitten, twice shy' approach, central banks will be extremely cautious in their easing cycles. In the Eurozone, as economic activity will accelerate in the second half

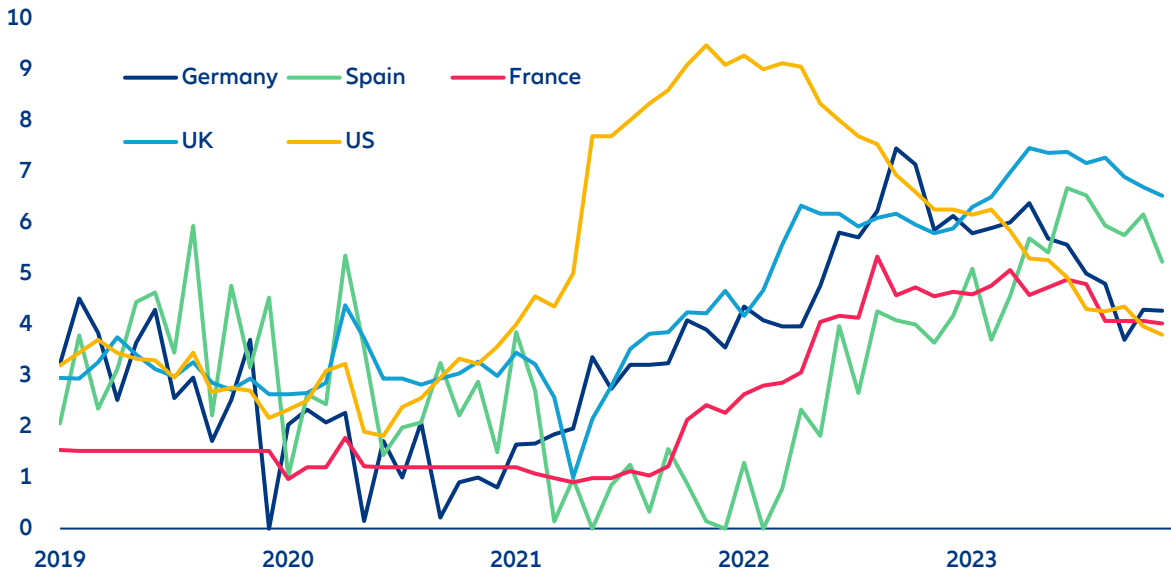
of 2024, the ECB will stop cutting after 50bps and wait to see if inflation continues to progress towards the target before continuing towards our expected terminal rate of 2.75% in 2025. Our call is therefore much more hawkish compared to the current market pricing of around 140bps of cuts next year. The main reason for this divergence is that we do not see a deeper recession materializing as our baseline scenario, despite some early indicators pointing in that direction.

Table 2: Inflation forecasts

Inflation (yearly %)	2021	2022	2023f	2024f	2025f
Global	4.3	8.4	6.6	4.6	3.6
USA	4.7	8.0	4.1	2.3	2.4
Latin America	13.9	14.9	23.4	15.0	9.2
Brazil	8.3	9.3	5.1	4.2	3.0
UK	2.6	9.1	7.1	3.8	2.6
Eurozone	2.6	8.4	5.5	2.5	2.1
Germany	3.1	6.9	5.9	2.6	2.2
France	1.6	5.2	4.9	1.8	2.0
Italy	1.9	8.2	5.8	2.2	1.9
Spain	3.1	8.4	3.6	3.4	2.2
Central and Eastern Europe	8.1	9.1	11.4	5.8	3.9
Poland	5.1	14.4	11.6	6.0	4.1
Russia	6.7	13.8	5.9	6.4	4.5
Türkiye	19.6	72.3	53.6	37.8	17.4
Asia-Pacific	1.7	3.7	2.7	2.6	2.3
China	0.9	2.0	0.5	1.6	1.7
Japan	-0.2	2.5	3.3	2.2	1.0
India	5.1	6.7	5.6	5.3	4.5
Middle East	15.8	10.3	7.7	5.6	5.1
Saudi Arabia	3.1	2.5	2.8	2.8	2.0
Africa	12.4	16.1	24.4	17.5	11.2
South Africa	4.6	6.9	5.2	4.2	4.5

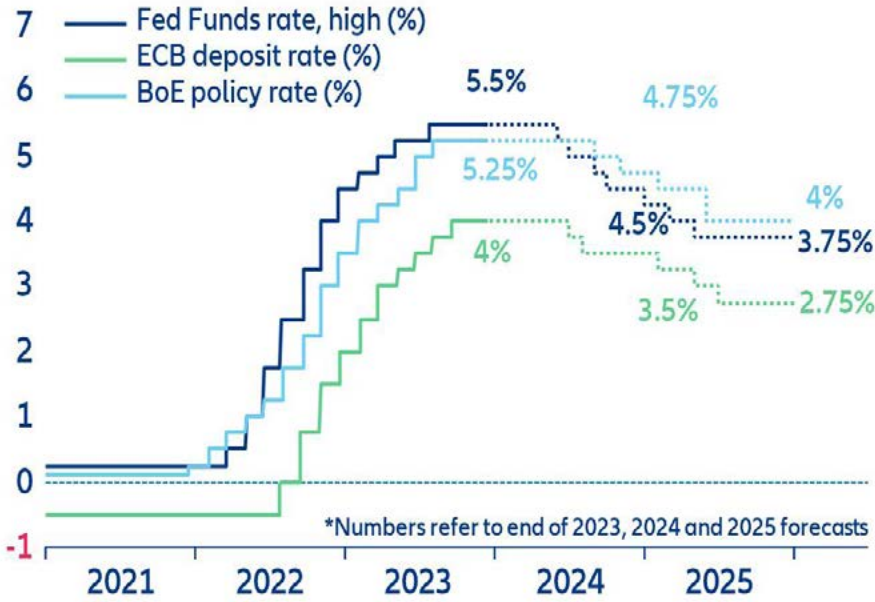
Sources: LSEG Datastream, Allianz Research

Figure 3: Indeed wage tracker on newly hired employees, % y/y



Sources: LSEG Datastream, Allianz Research

Figure 4: Monetary policy forecasts



Sources: LSEG Datastream, Allianz Research

Fiscal safety nets unwinding

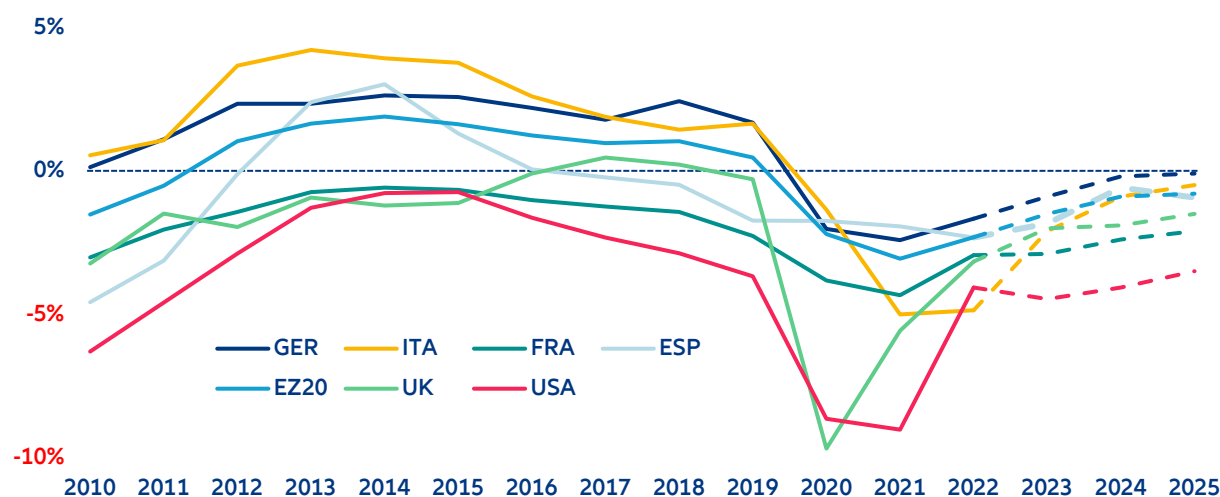
The unconstrained fiscal response implemented during the pandemic and energy crises has increased debt ratios and widened fiscal deficits across most advanced economies. Debt dynamics then benefited from the favorable differential between nominal growth and debt-servicing costs, which alleviated pressures on debt ratios. But going forward, the fiscal arithmetic (r-g) will become complicated, given the gloomier economic outlook and rising borrowing costs. We see debt-to-GDP stabilizing around current levels or declining only marginally; no significant downward trend is expected in the short/medium term. Moreover, highly indebted countries will also face higher interest debt burdens (i.e. above 4% of GDP in Italy), but lengthened debt maturity profiles should ease immediate rollover risks.

In the US, fiscal policy is expected to turn mildly restrictive in 2024 but a large fiscal deficit will remain amid a weaker economy. The US federal deficit grew to USD1,700bn in FY 2023 (-6.3% of GDP) amid lower taxation (notably on personal income), the end of Fed remittances to the Treasury, higher interest payments, higher social spending and higher payments to the FDIC.

We expect the fiscal stance to tighten moderately next year (to the tune of 0.4% of GDP) amid the debt limit agreement signed in June between the White House and Congress. However, the weaker economy that we expect in 2024, as well as increasing interest payments, should lead to a widening of the Federal deficit overall. We project the federal deficit for FY24 to widen to USD1950bn (-6.8% of GDP).

Though EU fiscal rules are set to be reintroduced in January, many Eurozone countries envisage a more gradual return to fiscal targets. On top of slowly declining debt-to-GDP, we do not expect the government budget deficits in France, Italy and Spain to return below -3% of GDP before 2026 despite the phase-out of energy support measures, though the German fiscal consolidation path will be more rigorous (see below). Overall, the Eurozone fiscal stance will normalize further and tighten by 0.6% of GDP in 2024, after 0.8% in 2023.

Figure 5: Fiscal stance forecasts, cyclically adjusted primary balance, % of GDP



Sources: LSEG Datastream, Allianz Research

The German budget dispute turns fiscal spending more restrictive. The German government has been bypassing its debt brake of 0.35% as structural debt in relation to potential GDP, particularly to finance its program to combat climate change. But the Federal Constitutional Court's ruling in November 2023 has stripped the government of the financing for climate and industrial policy projects: at least EUR60bn (costing -0.7pp of GDP spread over 2023-2027) and potentially a further EUR200bn set aside to aid the economic recovery from the economic stabilization fund are at stake. This situation also illustrates how Germany has managed to control its public debt. While government spending in relation to GDP was 45% in 2019, it is currently 48% (after over 50% in 2020 and 2021). This means that almost half of economic output is still funneled through public coffers, which leaves enough room for maneuver. But the German government has struggled to find consensus on setting priorities in its 2024 budget as it will have to comply with the debt brake and fiscally consolidate its structural balance at least in 2024 until further notice. This leaves it with EUR17bn savings from the core 2024 budget and EUR12bn from the Climate and Transformation Fund (KTF) in 2024, which adds up to a total of 0.7% of GDP. This gap was now announced to be financed by various measures such as the early expiry of the e-car purchase premium, a reduction of solar subsidies and environmentally harmful subsidies on fossil fuels, as well as labor market measures. At the same time, revenue for the KTF is to be increased by raising the CO2 price to EUR40 from 2024, which is EUR5 more

than previously planned. As Germany faces a challenging economic environment, this creates further uncertainty for firms and households. Due to a lack of reliable figures, we stick to 0.5% growth for 2024. But if things turn sour this could shave off approximately -0.3pp of GDP in 2024 and could potentially prolong the recession in an already very weak environment as it cuts competitiveness and torpedoed a catch-up effect of public and private investments. Germany's fiscal impasse highlights the need to prioritize investments on par with current consumption and finding a way to finance necessary investments in the years to come.

Reforming the EU fiscal framework has been politically complicated but reaching the last mile and reintroducing a revised set of rules still seems possible. Countries' different fiscal attitudes are reflected in the current (last-minute) negotiations. If Germany is calling for returning to discipline and clear debt-reduction targets and enforcement, countries such as France and Italy are advocating for less stringent and more gradual adjustment paths. We see member states and institutions willing to collaborate in the next fortnight and any strong actions by the European Commission (i.e. a return to the old rules opening EDP procedures) to be risky at the time of the 2024 European elections, potentially exacerbating some Eurosceptic attitudes that seem have not vanished across the bloc (as seen in the recent Dutch elections, for example).

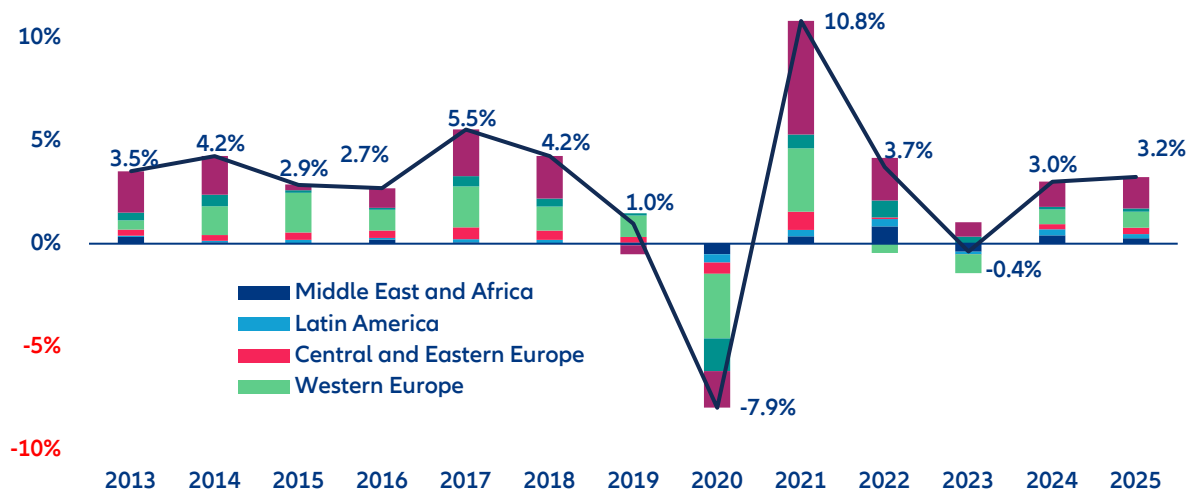
Global trade emerging out of the woods

After a tough year, global trade will likely end 2023 with a contraction of trade volumes by about -0.4% y/y.

Despite falling energy prices and the end of pandemic restrictions in China, which initially raised hopes for a quick economic rebound, the much-awaited rebound in global trade did not materialize. Europe experienced a notable decline in trade because of slowing economic momentum and a manufacturing sector still destocking and battling the energy crisis. In contrast, South America witnessed better-than-expected export growth. In 2024, global trade is expected to rebound timidly, with an

increase of +3% y/y in volume, as destocking will likely run its full course in 2024, Europe will come out of a second year of trade recession and Asia will lead the recovery. Germany is expected to post close to USD80bn in export gains, while Italy, the Netherlands and France are expected to register USD45bn, USD39bn and USD35bn in export gains, respectively. Although these gains do not represent huge boosts to their respective domestic economies, they add up to contribute significantly to the rebound in global trade.

Figure 6: Global trade forecasts, in volume, y/y growth



Sources: LSEG Datastream, Allianz Research

The Chinese consumer did not save the day

All eyes are on policy support. China's economy is battling a property sector downturn, record-low consumer confidence (and subsequently lower consumer spending per capita, given the negative wealth effects due to the continued fall in property prices) and limited fiscal and monetary policy support. In this context, we expect GDP to grow by +4.6% in 2024 and +4.2% in 2025. While the economy has bottomed-out after weakness in Q2 (+0.8% q/q compared to +1.5% pre-pandemic), monthly indicators suggest that economic activity remained weak in both the manufacturing and the non-manufacturing sectors in the last quarter of 2023. In

particular, trade figures started to improve in November. Export values rose for the first time since May (+0.5% y/y after -6.4% in October) while the level of export volumes hit a fresh high, supported by exporters reducing prices. Import volumes declined (-0.6% y/y after -3%) after hitting a record high in October, but they are likely to remain strong in the near-term as fiscal support boosts commodity demand. Looking ahead, the resilience of exports is unlikely to last. The recent strength is at least partly fueled by exporters cutting prices to gain market share. But this is not sustainable and is negatively affecting corporates' margins, which have dropped near

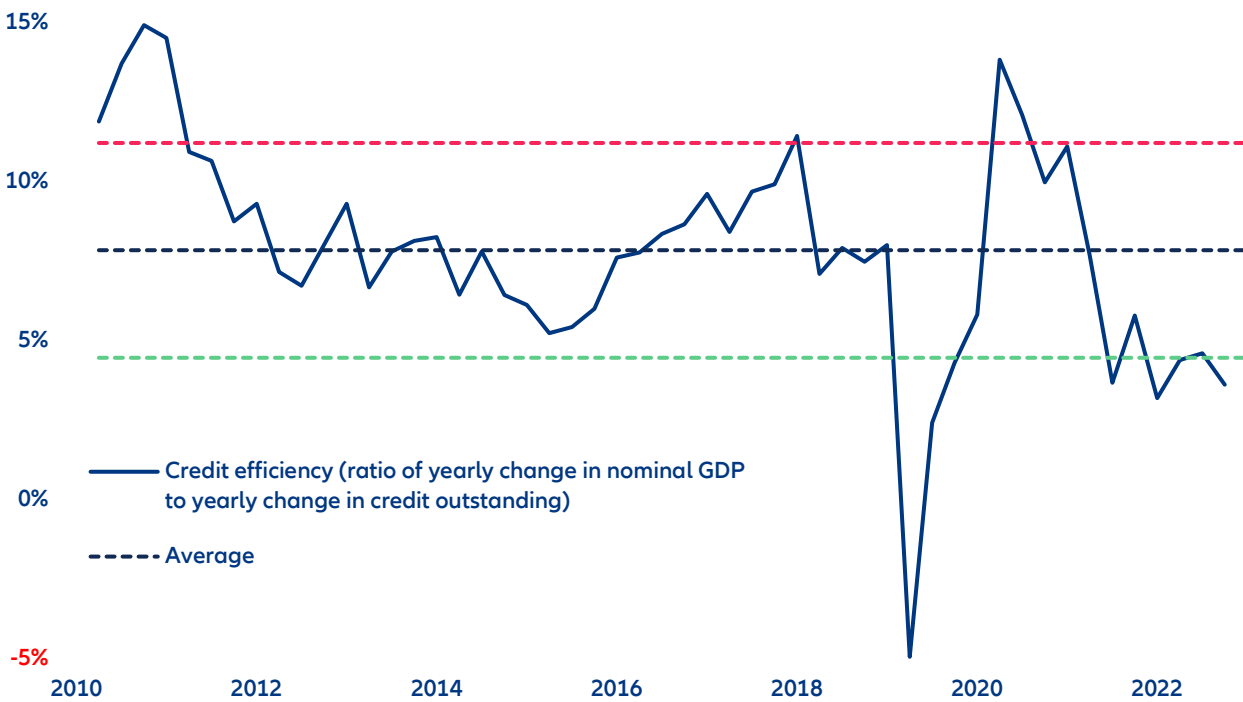
levels not seen since at least 2010, excluding the initial pandemic lockdowns. Overall, we expect exports to rise by +3% in volume terms in 2024 with flat export prices.

After reaching a record high of close to USD140bn in Q3 2022, the current account surplus has deteriorated since, reaching a two year low of USD63bn in Q3 2023.

This was primarily driven by higher imports of services in the recent quarters. On the capital and financial accounts front, net outflows of direct and portfolio investment seem to be widening the deficit in recent quarters. Investors are well aware about China’s challenges in the housing market, low consumer confidence and high local government debt. Against the renewed worries in the property sector, the Chinese authorities have stepped up

housing easing measures several times in order to reduce the housing glut and improve consumer confidence, which remains at a record low level not seen since 2015. We believe these measures are helping the property market stabilize and preventing further developers from defaulting. But there is still a long way to go before we see a pick-up in real estate prices. New home sales stand -20% below last year’s levels and new home starts contracted -65% vs. 2020-21 peaks. Hence, financing support is likely to be ramped-up as real interest rates remain above 3% for one-year maturities and above 4% for five-year maturities. Cutting rates further is a must in our view, along with easier credit conditions from banks, as financing conditions for private developers are too tight.

Figure 7: China credit-efficiency ratio



Sources: LSEG Datastream, Allianz Research

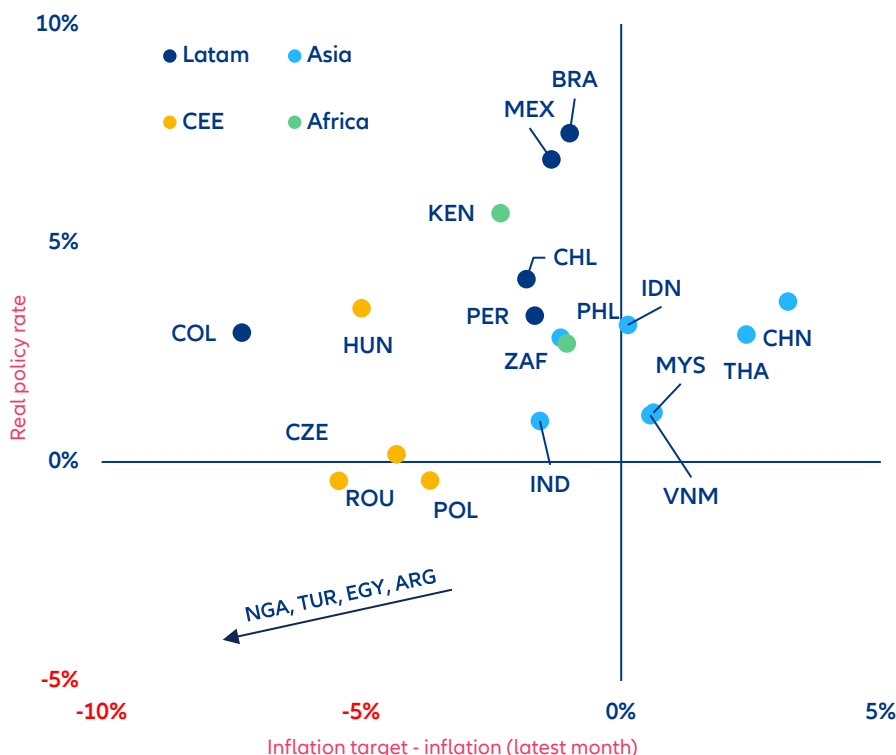
Selectivity is key in emerging markets

Interest rate cuts will become widespread in emerging markets (EMs) in 2024, while improving current account imbalances should continue to unwind; both elements provide tailwinds for the “re-emergence” of EMs.

After a tumultuous 2022, current account imbalances in EM have started to unwind (in part thanks to stabilization of energy commodities markets), which, together with early and decisive hikes, has given central banks some space (Figure 8) to proceed with the first interest rate cuts (Chile, Brazil and Peru in Latam or Poland and Hungary in Eastern Europe). We expect their regional peers to follow suit within the next six months, while EM Asia (excluding China, where the battle is against deflation) will remain on the cautious side and will wait until at least the second half of 2024 to deliver the first cuts. In other parts of the world, where there are still some current account shortfalls and where

the risks of balance-of-payments crisis are not fully off the table (e.g. Türkiye, Egypt or Nigeria), we could see additional hikes before any monetary easing – which in any case will not come before the second half of 2024. Given the particularity of these asynchronous interest rate cuts, we cannot rule out the return of FX pressures or temporary bond outflows, but the situation should improve in summer once central banks in AEs kick-off their respective monetary easing cycles and the USD gradually weakens. Likewise, the yields of EM sovereign bonds will decrease, helped by the global easing. From 6.6%⁵ currently, we expect them to reach 6.1% by the end of 2024 and 5.6% by the end of 2025. On foreign currency bonds, we also expect a decrease in spreads, but in this case it will not be as large (25bps compression until 2025), which would still leave borrowing costs considerably higher than in early 2021.

Figure 8: Widespread positive real policy rates in major emerging markets.



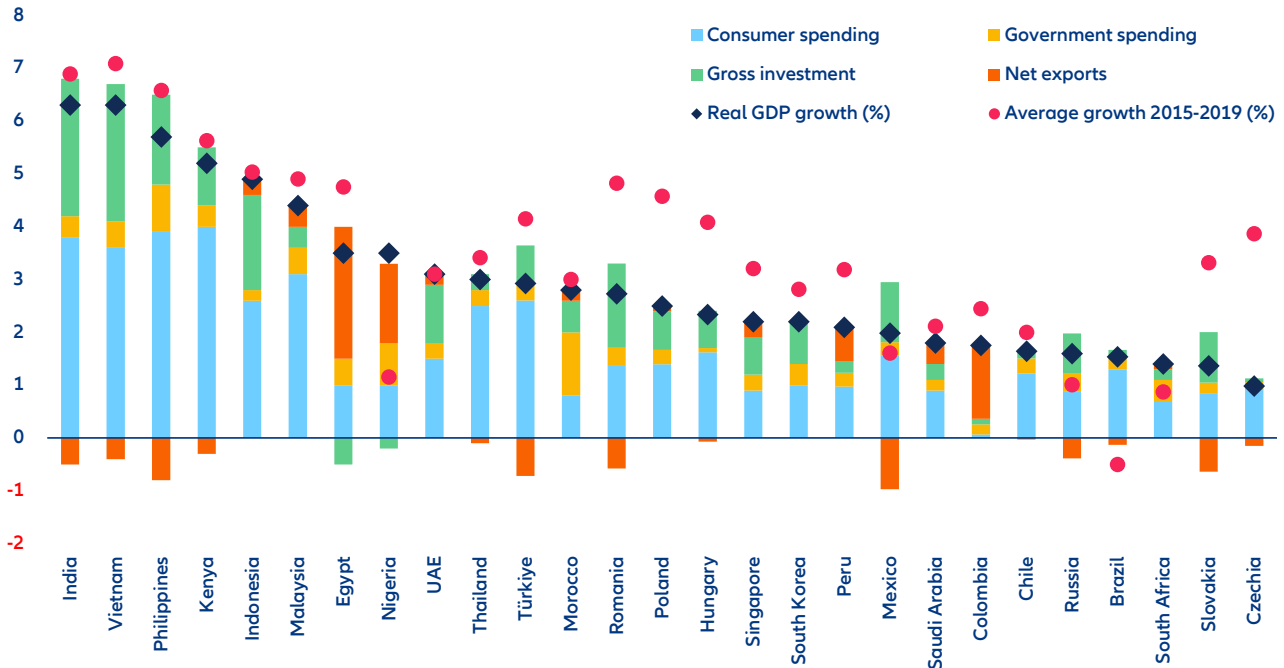
Sources: LSEG Datastream, Allianz Research. “Real policy rate” calculated as the latest inflation print minus CB benchmark rate. Contains all the updates until 11/12/2023.

⁵ These numbers are calculated using JP Morgan EM aggregate bond indexes.

However, the EM spectrum risks becoming more and more fragmented, with some powering ahead and others lagging behind. The main unknowns remain on the monetary policy side for some EMs and on the fiscal side for a larger number of countries. 2024 brings with it some significant maturities in sovereign debt repayment

that have accumulated and become more difficult to refinance at current rates. This could widen the gap between countries that are able to cope with the situation and those that could get dragged into a vicious debt spiral.

Figure 9: Emerging markets 2024 growth contributions forecast, y/y, %



Sources: LSEG Datastream, Allianz Research

The friend-shoring opportunity to gain traction in 2024-25. Initially, the motivation to shift production away from China primarily revolved around the concern of increasing labor costs. However, differences in ideologies and geopolitical considerations seem to be playing an increasingly important role in recent years. This year for instance, China lost its place as the largest trading partner of the US to Mexico. Amid this re-shuffling of trade and investment patterns, a number of emerging economies stand to gain, with early benefits being enjoyed by economies that remain in close proximity to the US – in terms of both physical and geopolitical distance. Further, as multinational firms based in China and abroad look to diversify away from China, rising labor productivity and lower labor costs in many of the economies in south and south east Asia make them an

attractive choice as China’s ‘plus one’. This is in addition to the fact that a number of economies in this region also have a stronger comparative advantage than China on global value-chain trade and strong trade complementarity with the US and the EU. Increasing inflows of direct investment provide suggestive evidence for the idea of friend-shoring, with significant gains especially for Indonesia, Vietnam and Malaysia. Broadly, ASEAN member countries seem to play an increasingly pivotal role in manufacturing and possess significant potential in the context of the green transition.

Looking at the US trade deficit shows a clear shift away from China towards other economies, especially in Asia, Mexico, Canada and Europe – despite the higher cost. In Q2 2023, the total US trade deficit widened

to -3.1% of GDP (+0.3pp from the previous quarter).

Asia-Pacific excluding China and India accounted for the largest share, representing more than one-third of the US trade deficit (-1.1% of GDP), followed by China (-0.9% of GDP) and Mexico (-0.6% of GDP). Looking at the period between the first quarter of 2018 and the second quarter of 2023, we find that the US trade deficit with China narrowed by +0.7pp, while the trade deficit with the Asia-Pacific widened by -0.6pp, with Mexico by -0.3pp and with Canada by -0.2pp. This is also consistent with the fact that between 2017 and 2022, the share of US imports from China declined by close to -5pp to 17.1% of total imports, while those from Vietnam (+2pp to 4%), Taiwan (+1pp to 2.8%), Canada, India, Thailand (+0.6pp each to 13.3%, 2.7% and 1.9%, respectively) and Mexico (+0.5pp to 13.6%) increased, broadly offsetting the share lost by Chinese imports⁶.

However, a complete US decoupling from China is not on the cards: Inter-linkages in the global supply chain still keep the US exposed to China as an end supplier.

The US may have shuffled its main trade partners in the Asia-Pacific region, but imports from China account for the largest share of total imports in Asian emerging economies (e.g. close to 35%, 33% and 23% in Cambodia, Vietnam and Thailand, respectively). Moreover, the economies that increased their market share of total imports in the US also increased their own shares of Chinese imports. A closer look at the growth in trade patterns of these economies reveals a positive correlation between the growth in exports from these countries to the US and a growth in imports by these countries from China. This underscores the fact that though the US has successfully reduced its 'direct dependence' on China, it is still indirectly buying its wares.

Corporates are digesting the higher-yield environment

Faced with rising interest rates, corporates have been adapting their strategies to mitigate the potential negative impacts.

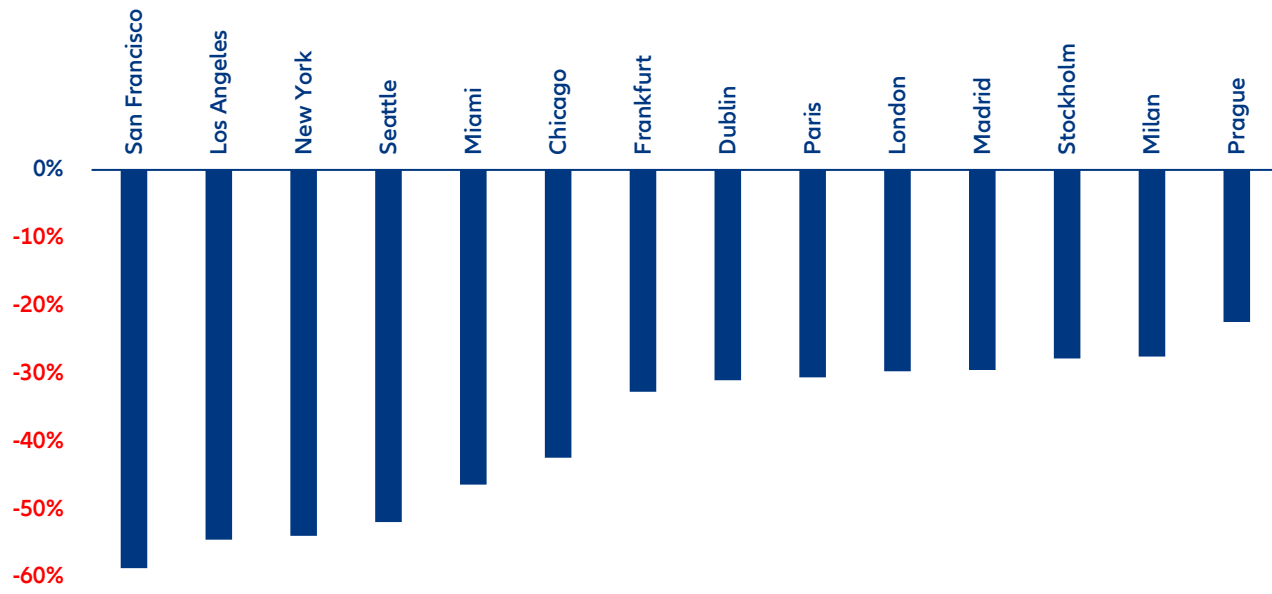
The increased cost of borrowing raised concerns about higher default rates. But although the latest data reveal an increase in insolvencies in most countries, the severity risk remains in check as it is mostly smaller firms that have been going bankrupt. Several factors have allowed larger corporates to remain in a relatively strong position. Firstly, corporates did not increase their debt: leverage ratios on both sides of the Atlantic are on par with 2018-2019 average. Secondly, firms have been borrowing at shorter maturities to mitigate increasing interest expenses. The average maturity of corporate bonds has been dropping consistently over the last couple of years; as a result, interest coverage for large corporates in both the US and in Europe stands close to 9. Nevertheless, beyond

small firms, there are some pockets of risks: real estate, the construction sector, utilities and renewable energy are facing significant headwinds. Notably, real estate and renewable energy are paying the price of significant asset devaluations (especially office and wind assets), resulting in financing issues (Figure 10).

With only 60% of the rise in interest rates passed through in most European countries, the full hit is still looming. This will lead to weaker revenue growth and a further ramp up of interest expenses, which could strain companies with less cash to meet their debt obligations. Although we do not foresee a risk of widespread corporate defaults, weaker firms with high leverage and heavy reliance on external financing for operations and investment will be increasingly challenged in 2024.

⁶ What to watch | November 24, 2023 (allianz.com)

Figure 8: Office property value (% change Q3 2023 – Q2 2022)



Sources: GreenStreet, Allianz Research





Capital markets outlook

Rates struggle between policy pivot and supply whereas risky assets will be put to a test

Despite shifts in monetary policy, longer-term interest rates are unlikely to decline significantly in 2024 as they face upward pressure from supply-side factors, in particular in the US. In 2023, aggressive central bank tightening and a higher-for-longer narrative pushed yields to levels we have not seen in more than a decade. Going forward, we do not see a material level change despite the monetary policy pivot. After all, the terminal rates to be reached in 2025 are way above the zero or even negative interest rate policy witnessed in the last decade. Additionally, excessive supply of government bonds amid high fiscal deficits and ongoing quantitative tightening will prevent yields from dropping much from current levels.

German yields were pushed well below our fair value estimates recently. This rally can be explained by several factors. Firstly, there is a prevailing expectation of a potentially more severe economic downturn in the Eurozone, driving up demand for safe-haven assets. Secondly, the market is anticipating strong monetary easing measures in 2024. Lastly, fiscal constraints in Germany have diminished expected bond supply. As we foresee fewer rate cuts from the ECB and only a moderate economic downturn followed by a rebound in the second half of 2024, we believe that the current amount of excessive safe-haven demand for German debt may be overdone. As a result, we expect German yields to see a modest increase from their current levels in 2024 before declining again in 2025.

The Italian sovereign bond market has stabilized after being hit by “old” concerns. The autumn round of rating actions by major agencies has concluded with no so-feared downgrades, alleviating some pressures in the Italian bond market. Indeed, spreads widened in October when the Draft Budgetary Plan was released, envisaging lower growth and a higher fiscal deficit (and any debt reduction). Moreover, the retail-oriented H2 2023 sovereign issuances have found good appetite domestically, providing further relief from the ECB’s quantitative tightening.

Volatility in the rates markets is about to fade as uncertainty about inflation and monetary policy recedes. In 2023, bond market volatility hovered at levels typically reserved for economic shocks akin to the Global Financial Crisis, the Covid-19 pandemic or the outset of Russia’s attack on Ukraine. Our analysis indicates this sustained volatility largely stems from rising monetary policy uncertainty, a shift from last year’s predominant inflation concerns. Moving into 2024, as the landscape of the future inflation and monetary policy path becomes more visible, we expect a noticeable decrease in rates volatility.

The US dollar should remain relatively strong in the short term before a gradual correction starting in Q2 2024. Favorable growth dynamics over the year could maintain momentum in the short term and high interest rates should still support the currency in the first quarter. Thereafter, our scenario of a soft landing for the US economy, the start of a monetary easing cycle by the Fed and an improved global outlook – i.e. a resumption of global trade, better economic conditions without major accidents in China – should favor risk sentiment in the markets and weigh on the USD, especially in H2. The euro should benefit from this improved global environment, on top of relatively better growth conditions in the Eurozone, especially in Germany, and a

favorable interest rate differential (we currently expect only a 50bps rate cut by the ECB). However, we note that the downside risks for the euro are high as recession risks are not negligible, which could lead the ECB to possibly start a more pronounced monetary easing cycle in the first half of the year. In addition, the energy crisis is currently off the table, but could resurface if geopolitical risks rise again. In the medium term, structural issues, especially the less favorable terms of trade, are also working against the currency.

The combination of a halt in the AI market frenzy and uncertainty around the monetary policy paths will lead to an exciting year in advanced economies’ equities – but returns will be much less exciting.

Advanced economies’ equities have performed above expectations in 2023 after a difficult 2022. While most of the S&P 500 performance can be explained by a handful of stocks (Figure 11) and the excitement over Artificial Intelligence (AI)⁷, the much less technological and less concentrated Euro Stoxx⁸ index will also post close to 20% gains this year. In this case, the expectations of an economic rebound (in relatively cheaper stocks) and the aggressive pricing of policy cuts next year are the drivers of this change. We think 2024 will put to test both drivers, leading to an increase of volatility and a slight correction in the first half of the year as market optimism about rate cuts cools down (especially in the Eurozone). The improvement of macroeconomic conditions in the second half of the year and the confirmation of the first cuts will revert the previous losses, although according to our projections it will not be enough to trigger a rally, and yearly performance will remain around 5% in 2024, with the US slightly outperforming the Eurozone. In 2025, with further cuts and higher growth in both the US and the Eurozone, we could see a modest boom, with prices growing around 10%. With regard to the US markets, we are expecting more balanced growth, with the cooling down of AI hopes (due to expensive valuations and worries about the impact of new regulation) and more support from other sectors (e.g. industrials).

⁷ Although AI is not (yet) a primary driver of their earnings, some of these companies play a crucial role in development or/and application of AI.

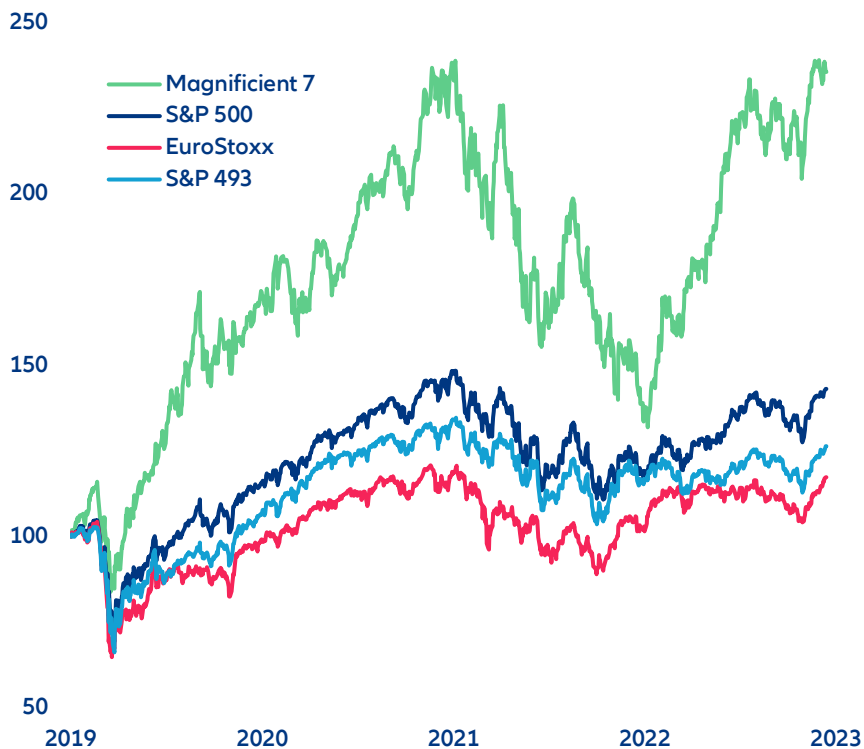
⁸ We work with a subset of Euro Stoxx 600 made solely of companies listed in Eurozone countries.

Table 3: Capital market forecasts

year-end figures	Last	Unit	2022	2023f	2024f	2025f
EMU						
Government Debt						
ECB deposit rate	4.00	%	2.00	4.00	3.50	2.75
10y yield (Bunds)	2.13	%	2.56	2.20	2.40	2.30
10y EUR swap rate	2.68	%	3.14	2.70	2.90	2.70
<i>Italy 10y sovereign spread</i>	169	bps	213	170	150	140
<i>France 10y sovereign spread</i>	52	bps	55	50	40	40
<i>Spain 10y sovereign spread</i>	96	bps	109	100	80	70
Corporate Debt						
Investment grade credit spreads	136	bps	166	140	140	125
High-yield credit spreads	397	bps	494	410	430	390
Equity						
Eurostoxx (total return p.a.)	20 ytd	%	-12	19	4	9
US						
Government Debt						
Fed Funds rate (high)	5.50	%	4.50	5.50	4.50	3.75
10y yield (Treasuries)	3.91	%	3.83	4.10	3.80	3.60
Corporate Debt						
Investment grade credit spreads	104	bps	138	115	115	110
High-yield credit spreads	347	bps	479	370	410	350
Equity						
S&P 500 (total return p.a.)	25 ytd	%	-18	24	6	11
UK						
Government Debt						
BoE rate	5.25	%	3.50	5.25	4.75	4.00
10y yield sovereign (Gilt)	3.79	%	3.67	3.80	3.90	3.60
Corporate Debt						
Investment grade credit spreads	134	bps	192	140	140	130
High-yield credit spreads	504	bps	663	525	550	475
Equity						
FTSE 100 (total return p.a.)	7 ytd	%	5	6	4	8
Emerging Markets						
Government Debt						
Hard currency spread (vs USD)	231	bps	273	235	230	210
Local currency yield	6.42	%	6.86	6.60	6.10	5.60
Equity						
MSCI EM (total return p.a. in USD)	7 ytd	%	-20	6	5	10
Others						
EUR USD	1.10	\$ per €	1.07	1.09	1.12	1.14

Sources: LSEG Datastream, Allianz Research

Figure 11: Performance of main US and Eurozone equity indexes. Rebased to 100 as of 31/12/2019.



Sources: LSEG Datastream, Allianz Research

Corporate credit spreads fared better than expected in 2023 despite the sharp tightening cycle. With the exception of the post-SVB turmoil, spreads have remained at relatively low levels compared to the high yields in risk-free assets. Particularly noteworthy was their contained widening compared to the increase in sovereign yields during the “higher-for-longer” sell-off between August and October. This resilience could be summarized by saying that markets continue to believe in a soft landing. The immaculate disinflation and the buffers built over the low-interest-rate-years will allow central banks to normalize rates before the transmission of monetary policy fully hits corporate balance sheets and before we see major cracks in the economy.

But all that glitters is not gold: it is important to make a distinction between the overarching narrative (rather constructive) and the fine print (potential losses in market segments). Looking at the big picture, and although we are not as optimistic as markets when it comes to interest rate cuts – especially in the Eurozone – we think that the spreads of investment grade companies will end the year at similar levels as they are today (US IG: 115bps, EZ IG: 140bps). Although in principle this would indicate a year with little movement in spreads, we think there will be entry opportunities as credit spreads widen during the first half of the year. A correction in excess optimism when it comes to policy rate cuts, the fact that acceleration of the economy will only kick in in the second half of the year and, in the meanwhile, the effects of higher-for-longer interest rates (i.e. growing interest expenses as we navigate the refinancing wall) will create some investor anxiety. The gradual compression in the second half of the year will extend into 2025 (year-end IG spreads: 110bps in the US and 125bps in the EZ).

Financial cracks under the surface and liquidity squeeze to continue

The SVB banking crisis in March 2023 showed how quick financial risk can materialize but also how fast policy makers stepped in. With policy rates reaching historic highs (ECB) and increasing at unprecedented speeds (Fed), the eruption of financial sector risks is inevitable and likely to persist. And both sides of the balance sheet are worth highlighting. Asset side vulnerabilities include significant unrealized fixed income losses held by banks and insurers when longer dated bonds lose value amid rapidly rising interest rates. The Bloomberg aggregate bond index shows that the market value of all bonds dropped from USD7trn above the face value to USD5trn below the face value. Asset owners have therefore lost around USD12trn in little more than a year. SVB was one example where these losses were painfully realized. However, the crisis also showed that there is a lender of last resort even in times of monetary restrictiveness. The Fed's swift introduction of the Bank Term Funding Program during a critical weekend forestalled a potential bank run. This program, offering generous borrowing conditions, coupled with an effective rise in deposit insurance from USD250,000 to an unlimited amount, signaled robust support to depositors beyond SVB.

On the liabilities side, debt-refinancing challenges loom for highly indebted sectors such as real estate but also non-profitable companies in a higher yield environment. These issues are compounded in the commercial real estate sector as it faces dual challenges: reduced income from the work-from-home trend and increased borrowing costs due to inflation-driven monetary tightening. The recent insolvency of Austria's largest private real estate company Signa exemplifies these pressures.

Risks of another SVB- or Signa-moment remain high going forward. But we expect these risks to stay contained and to not trigger a systemic crisis. One reason is the monetary policy pivot, with central banks taking the foot of the brakes in 2024. Second, in case of an imminent crisis, both fiscal and monetary policy makers are on standby. And third, we do not see a repetition of a 2007-like housing crisis. House prices are unlikely to drop much further from current levels as demand outweighs supply in many markets and wealth effects from the current housing correction should be more muted compared to 2007 when home equity credit and other consumer leverage were much larger.



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