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Allianz Research

Climbing the wall of worries

Summer Economic Outlook

Executive Summary

Ludovic Subran,
Chief Economist
ludovic.subran@allianz.com

Ana Boata,
Head of Economic Research
ana.boata@allianz-trade.com

Andreas Jobst,
Head of Macroeconomic & Capital Markets Research
andreas.jobst@allianz.com

Ano Kuhanathan,
Head of Corporate Research
ano.kuhanathan@allianz-trade.com

Jordi Basco Carrera,
Lead Investment Strategist

Maxime Darmet,
Senior Economist for France & US

Pablo Espinosa-Uriel,
Investment Strategist

Jasmin Gröschl,
Senior Economist for Europe

Françoise Huang,
Senior Economist for Asia Pacific

Roberta Fortes,
Senior Economist for Latin America

Maxime Lemerle,
Lead Analyst for Insolvency Research

Maria Latorre,
Sector Advisor B2B

Maddalena Martini,
Economist for Italy & Greece

Luca Moneta,
Senior Economist for Africa & Middle East

Manfred Stamer,
Senior Economist for Emerging Europe & Middle East

With the assistance from Pierre Rouillard, Nikhil Sebastian and Patrick Hoffmann.

- **Some larger economies slipped into recession earlier this year amid a difficult global economic outlook, with GDP growth averaging at only +2.5% and +2.3% in 2023-24, respectively.** The manufacturing and global trade recessions dragged several economies into a technical recession in Q1 2023 (Germany, Singapore, Taiwan). Residual effects of tighter monetary policy are set to shape a tempered 2023-24 growth scenario, with the US and Eurozone heading towards a soft landing and a subdued rebound in 2024, especially as Europe faces the prospect of a tighter financing landscape for longer. Most advanced economies are expected to avoid a full-fledged recession but will remain in a low-growth environment. Emerging markets face mounting pressure due to internal and external imbalances. Social fatigue is also likely to unfold amid a general convergence towards lower growth rates on the back of decelerating commodity prices, a higher USD, rising liquidity strains and delayed rate pivots.

- **Determined to fight inflation, central banks are expected to decelerate their hiking cycles throughout the summer but not pivot before spring 2024.** Positive real interest rates will push non-payment risk higher. Given sticky core inflation, notably due to services prices, high interest rates will remain in advanced economies. The latter half of the year may bring about an increasingly politicized monetary stance as central banks prioritize inflation control over growth support. In the US, resilient economic activity and less acute financial stability concerns means tighter monetary policy. Following the pause in June, two final rate increases of 25bps each are likely in July and September, leading to a 5.75% terminal rate. The Eurozone continues to face a challenging monetary policy environment as persistent price pressures, particularly in services, reinforce the need for further rate hikes. We expect two additional hikes for July and September, resulting in a 4.0% terminal rate. This would imply that the ECB maintains a restrictive stance in 2023, despite an expected stagnation in growth until Q1 2024. The Bank of England is expected to be the last to pause with three more rate hikes at 5.5% by year-end. If interest rates rise by 200bps, we calculate that the share of fragile SMEs would rise to 18% in the UK, 14% in France, 7% in Germany and 10% in Italy, i.e. back to 2019 levels. The bounce back in insolvencies is spreading across sectors and to large firms: We expect them to increase by +21% in 2023 and +4% in 2024.

- **A lot of the economic resilience comes from the labor market; companies are hoarding labor despite falling margins, which cannot last for long.** Global corporate revenues continued to increase in Q1 (+2.7% y/y) but much slower than in previous quarters (+4.0% in Q4 and +9.0% in Q3). Earnings fell for two quarters in a row. Wage pressures as a percentage of gross value added remain above average in the Eurozone, most notably in France, Germany and Italy. Since other costs excl. wages cannot be reduced indefinitely and pricing power has been fading in most sectors, we see margins squeezing in the coming quarters, increasing pressures on companies that scaled back hiring, but "hoarded" labor amid deteriorating demographic trends and the expectations for a short-lived moderate recession.

- **The prevailing fiscal stance remains supportive, yet a serious shift towards fiscal consolidation is expected next year as climbing interest rates limit flexibility.** In Europe, the cyclically adjusted fiscal expenditure, representing the fiscal stance, lingers near peak levels. The structural deficit, inclusive of energy-related measures, is set to drop by around 0.5pp of GDP this year, correspondingly reducing GDP growth. Despite subdued growth, the cyclical impact of a more restrictive fiscal policy will not be substantial. Shrinkage in fiscal space may require challenging policy compromises as governments strive to address key structural issues arising from the recent crisis, including green economy transitions and crucial pension and tax reforms. In the US, a debt-ceiling agreement between the White House and Congress Republicans will result in spending caps, focusing narrowly on federal non-defense discretionary spending. This limits the degree of fiscal policy tightening. Nonetheless, accelerated fiscal consolidation is anticipated in US States due to a soaring interest bill and probable federal transfer cutbacks. We expect a negative general government fiscal impulse amounting to 0.7% of GDP in 2024, and forecast a broadening fiscal deficit to -7.8% of GDP (from -7.3% in 2023) amid a weaker economy induced by Fed policies and interest payments rising above 4% of GDP.

- **Expectations of restrictive monetary policy and stronger-than-anticipated economic resilience present short-term upside risks for long-term yields, while euphoric equity markets are heading towards challenges.** Market participants are speculating on central banks' terminal rates, hence fluctuations in realized and projected policy paths significantly affect the long end of the yield curves. Our forecast, based on stronger economic performance. Our forecast, based on stronger economic performance in the US and Eurozone for 2023 and 2024, as well as inflation estimates exceeding consensus, suggests ongoing upward risks for long-term yields in the short run as the market adjusts to revised central bank expectations. However, valuation models suggest lower absolute yields in the mid to long term. Overall, we expect a gradual decline in long-term yields once central banks reach their terminal rate, with the 10-year US Treasury yield ending at around 3.8% by the end of 2023 and then dropping to 3.3% in 2024, and similar patterns for the 10-year Bund. Despite their strong performance so far, equity markets should see downward pressures in the next few months. Weaker long-term growth, elevated short-term rates, falling inflationary pressures and deteriorating liquidity are poised to exert such pressures on valuations. The US and Eurozone are likely to exhibit regional divergences, with the US displaying a stark gap between economic leading indicators and current market pricing. Conversely, in the Eurozone, economic optimism aligns more with current market conditions, suggesting a more positive outlook if economic expectations are realized. This suggests a drop in margins before an anticipated rebound later in 2024.

- **What could go wrong?** We are heading towards a very politically charged 2024 with elections upcoming in economies accounting : for close to 75% of global GDP: Austria, EU elections, India, Mexico, Poland, Romania, Russia, South Africa, Taiwan, the US, UK etc. Beyond politics and although a full-scale financial crisis has been dodged for now, the risk of further bank failures remains as efforts to reassure investors falter. Potential bailouts of bankers and tech start-ups might have also have political implications in the run-up to the US 2024 Presidential campaign. Higher-for-longer inflation also increases the risk of a policy mistake by central banks, which will need to maintain a more restrictive monetary stance. U.S. monetary tightening and overshooting particularly by the Federal Reserve could prolong the current economic downturn and delay the recovery. Also renewed energy supply constraints in Europe, for instance as a result of a cold winter in 2023-24, could bring back the specter of gas rationing and push real growth in most countries into negative territory until mid-2024. However, a ceasefire between Russia and Ukraine would help reduce much of the prevailing uncertainty about the outlook and would allow for resources to be allocated more efficiently, including through strengthening strategic trade relationships that are currently under strain but critical to tackling important secular challenges (slowing globalization, rapid digitalization and effective de-carbonization). Also a more globally-oriented re-opening of China's economy could revitalize flagging global trade and accelerate normalization of inflation.

Economics - no recovery before mid-2024

The global economy still struggles to recover from the energy crisis, even as the full impact from tighter monetary policy is yet to materialize. We continue to expect moderate global growth in 2023-24, with a continued drag from the cumulative impact of monetary policy tightening on economic activity and employment. But we have slightly raised our growth projections for certain major economies. The US and Eurozone will experience a soft landing in 2023, followed by a subdued recovery in 2024. Europe in particular is likely to face tighter-for-longer financing conditions. Global growth is likely to slow to +2.5% and to stay at +2.3% in 2024, with significant divergence between advanced and emerging market (EM) countries. Advanced economies overall will avoid negative annual growth in 2023 (+1.5% in the US, +0.5% in the Eurozone, +0.2% in the UK) and in 2024 (+0.7% in the US, +1.0% in the Eurozone, +0.5% in the UK). However, pressures on EMs are likely to keep building due to rising internal and external imbalances, especially for commodity importers. Growth is expected to rebound in Asia-Pacific in 2023 at +4.5% supported by China growing above expectations at +5.8% in 2023, and slightly decelerate in 2024 to +4.1%. However, growth will slow down in Central and Eastern Europe, the Middle East and Latin America in 2023 (+1.2%, +2.7% and +1.6%, respectively) before rebounding, or remaining at similar levels, in 2024.

The Eurozone economy has fallen into a mild technical recession (since Q4 2022) and still struggles with high inflation as tighter financing conditions weigh on domestic activity. Overall, the economy contracted by -0.1% q/q in Q4 and Q1. Weak consumption and investment dynamics as well as a challenging external environment are the key drivers behind the current stagnation. Despite the shutdown of Russian gas flows, a milder winter in 2022-23, decreased gas consumption (-10%) and the rapid switching to alternative energy sources prevented a stronger recession. However, confidence indicators, such as the PMI for May or business-cycle expectations for June, point to an incipient reversal of the positive soft data momentum since the beginning of the year, which is underpinned by a rotation to services carrying the growth momentum. Improving net trade and rising new orders in services offset lower manufacturing PMI, which resulted in a Composite PMI that would otherwise be consistent with a solid recovery. The still relatively tight labor market has kept wage pressures high but stubbornly high inflation has chipped away at real household incomes. Thus, consumers will remain cautious over the coming months amid an elevated cost of living and rising interest rates. During the last quarter, the Eurozone economy was dragged down by lower household and government consumption. These factors offset a +0.6% rise in investment and a positive contribution from trade. We expect the Eurozone to remain in a stagflationary muddle-through phase, averaging merely +0.5% growth this year, followed by a shallow recovery of +1.0% in 2023. This is a small upward revision relative to our last forecast in Q1 2023, which assumed significantly weaker growth in the larger Southern economies (Italy, Spain and Portugal), which showed unexpected resilience throughout the first quarter of the year, mainly due to stronger-than-expected exports of services (tourism).

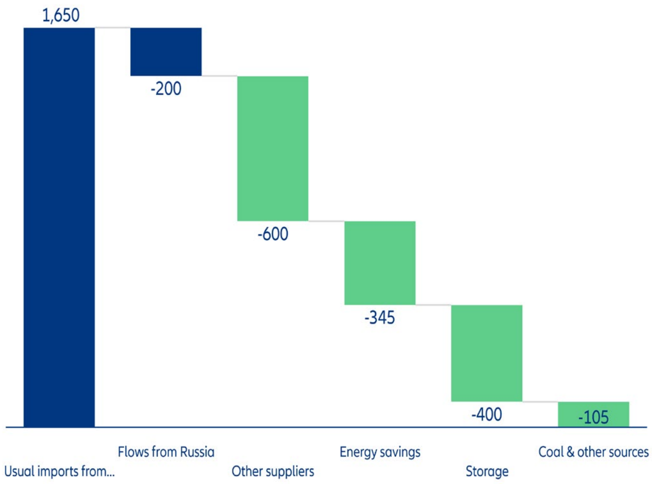
Assuming that energy savings from last winter are sustainable, we expect no energy gap for the next winter. Gas storage levels remain high (over 70% as of 06 June). In the event of a very cold winter, Europe would probably face price tensions and dig deep into storage but we believe the region will overcome that eventual hurdle. It is likely that China will compete in the race for LNG as it imported -20% less compared to normal in 2022, which could divert some of the supply from Middle Eastern countries or Australia towards China, and create upside price tensions.

Figure 1: Global real GDP growth

Growth (yearly %)	2021	2022	2023f	2024f
Global	**6.0**	**3**	**2.5**	**2.3**
USA	**6.0**	**2.1**	**1.5**	**0.7**
Latin America	**6.8**	**4**	**1.6**	**1.7**
Brazil	5.3	3.0	2.1	1.2
UK	**7.6**	**4.1**	**0.2**	**0.5**
Eurozone	**5.4**	**3.5**	**0.5**	**1.0**
Germany	2.6	1.9	-0.1	0.8
France	6.8	2.6	0.6	0.9
Italy	7.0	3.8	1.1	0.7
Spain	5.5	5.5	2.0	1.6
Russia	5.6	-2.1	1.0	1.4
Turkey	11.4	5.6	3.3	3.8
Central and Eastern Europe	**6.2**	**4**	**1.2**	**2.8**
Poland	6.9	5.1	1.5	2.7
Asia-Pacific	**6.4**	**3**	**4.5**	**4.1**
China	8.5	3.0	5.8	4.5
Japan	2.2	1.0	1.3	1.1
Middle East	**4.1**	**6.7**	**2.7**	**2.6**
Saudi Arabia	3.9	8.7	3.8	2.9
Africa	**5.8**	**3.7**	**3.2**	**3.6**
South Africa	4.9	2	0.7	1.4

Source: Allianz Research

Figure 2: Europe gas consumption and storage levels



Sources: ENTSO-G, Allianz Research

Deindustrialization in Germany: bogeyman or necessary step for structural change?

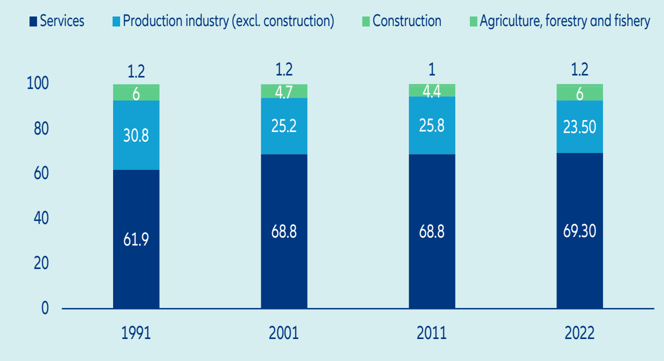
Facing the perfect storm of high energy prices and aggravated structural challenges, is Germany at risk of deindustrialization? The German business model is characterized by a vertically integrated industrial value chain, including a large industry-services network. This value chain has proven to be an advantage in global competition and has been able to compensate for some cost disadvantages (wages, taxes, regulation, energy). The network is supplemented by an efficient and globally active logistics sector and customer-specific after-sales services. The share of compound value added from the demand for services by industry ranges between 8.8% and 11.5% of the overall value added. Due to this close interdependence, the service sector also indirectly contributes to exports (54% of all service exports), which are higher than the 46% of direct exports of services. The German model is globally integrated and regionally balanced, but the devil is in the details.

Contrary to the theory of creative destruction, no new sectors or economic areas are in sight that would replace old established industries in Germany. A loss of energy-intensive industries and their industry-based value creation would lead to a massive outflow of wealth abroad. Energy-intensive industries generate about 20% of industrial value add in Germany and employ about 16% of the industrial workforce. Consequently, these industries have a significant impact on Germany's economic prosperity. The chemical industry and metal production are among the most research-intensive industries and produce more innovations on average than companies in other manufacturing sectors. Yet, the transformation affects all areas of the economy and will sooner or later also have to take place all over the world. Still, Germany cannot expect a Big Bang like in the UK in the 1980s, and it does not have a Silicon Valley from which innovations for future industries such as tech and information could emerge. The transformation process is already in full swing and might soon become more potent. Increasing automation has led to the loss of many jobs in manufacturing. But we also observe that companies have begun to relocate their production or build new plants abroad, leaving Germany for locations with cheaper energy, such as the US or Asia. The proportion of the manufacturing industry in the total gross value added has been falling in Germany since 1991. Industry accounts for 23.5% of German GDP in 2022, compared to 30.8% in 1991 (Box 1, Figure 1).

The industry must transform, but higher energy prices and structural change do not necessarily lead to deindustrialization. The changes in the German economic structure have been ongoing for decades and will be amplified by the structural challenges ahead. Germany will not compete internationally due to low energy costs, but through other factors. This logic can already be seen in wage costs, which are very high compared to other industrialized countries. Nevertheless, the share of gross value added in the manufacturing sector stands at 20.4% even though employment has fallen sharply (Box 1, Figure 2). Germany restructured its industry and was thus able to keep industrial production in the country. Companies have built a comparative advantage in high-value-added industries, such as motor vehicle manufacturing and engineering. Labor-intensive tasks were shifted abroad. The comparative advantage is now primarily based on a highly qualified workforce, good regulatory framework conditions, high levels of research activity and efficient production technologies. Higher energy prices will have to amplify this.

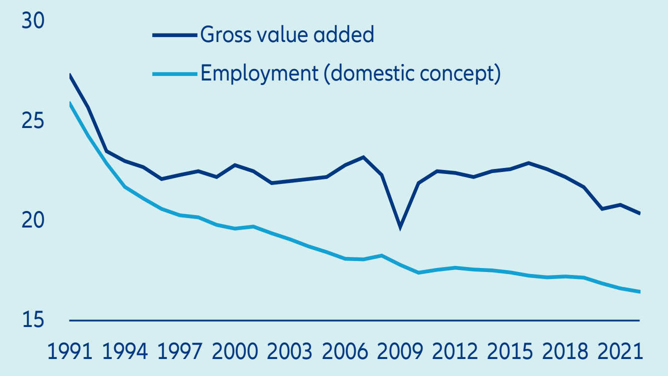
Nevertheless, changes are to be expected. Energy-efficient companies will be among the winners, while other companies will exit the market. In the future, Germany will produce products with a lower energy intensity. As a result, part of industrial production, especially in the energy-intensive area, could migrate. For most companies and industries, change cannot be prevented as subsidizing energy prices over the long run is neither feasible nor affordable. To support, policies need to focus on improving the framework conditions; securing necessary investments for an adequate supply of cheap, low carbon energy and promoting research and development of new products and services with potential for value add.

Box, Figure 1: Share of economic sectors in German GDP, in %



Source: Allianz Research

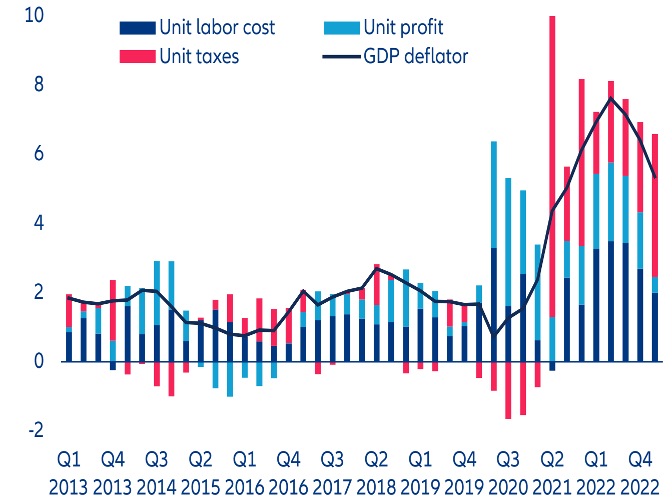
Box, Figure 2: Gross value added and employees in manufacturing in Germany, share of total in %, 1991 – 2022



Sources: Eurostat, Allianz Research

US domestic spending surprised on the upside, but the outlook remains a borderline recession. Several temporary factors have pushed us to revise on the upside our growth forecasts. First, the absorption of backlogs in manufacturing and construction is taking longer than expected, although the lingering weakness in new orders should push production lower in the coming months. Second, the policy mix is less restrictive than initially thought. The fiscal impulse is expected to be less negative as the debt-ceiling agreement endorsed more modest spending restraint than expected. In addition, the gradual rolling-out of the Biden administration's industrial policy measures, such as the Inflation Reduction Act and the CHIPS Act, are buoying up investment in new manufacturing facilities. Against this backdrop, tighter monetary policy is slow to bite on the back of strong household balance sheets and still tight labor markets. The housing market has started to stabilize at a low level. Real wage growth is accelerating, which should bring support to households' income and spending as strong consumer credit growth should falter by the end of the year as more banks plan to cut back on lending.

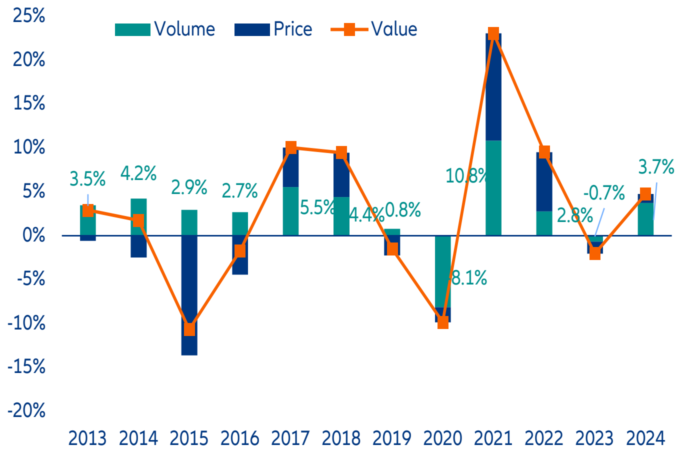
Figure 3: Corporate labor costs, profits and taxes (% y/y)



Sources: Refinitiv Datastream, Allianz Research

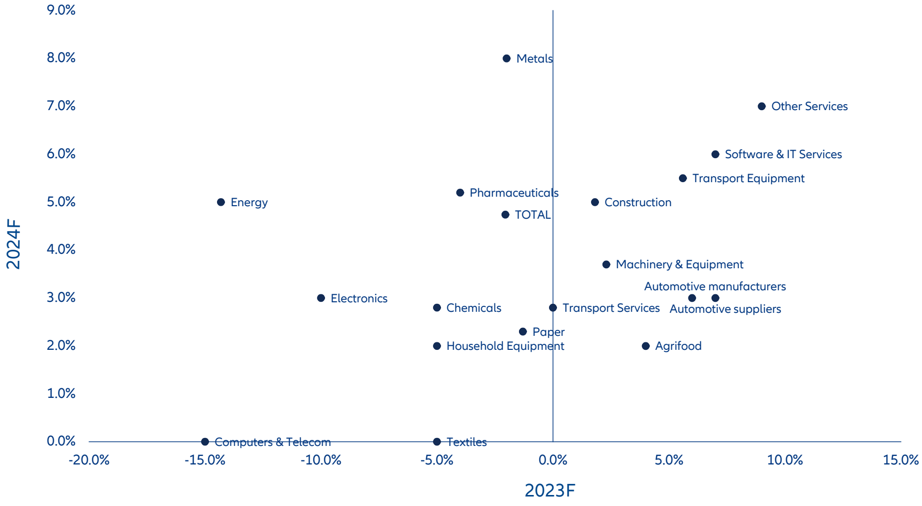
The global trade recession deepens. According to the latest data, global trade of manufactured goods decreased in the first quarter of the year (-0.9% q/q in volume terms), following a decline of -2.0% in the last quarter of 2022. This is consistent with our own global trade growth forecasts for 2023 of -0.7% in volume terms. We expect a modest recovery in the second half of the year, triggered by corporates rebuilding inventories, after a recession in the first half. In value terms, we expect -2.1% as inflationary pressures are fading with lower commodity prices, decreasing global shipping rates and many other input prices. At the same time, the USD is getting stronger. Western Europe and especially the sluggish German industry is behind this slowdown of global trade. As demand for manufactured goods slows down and many industrial firms have stockpiled inventories, the industrial sector is now facing oversupply. As a result, supply-chain pressures are receding and we do not expect them to pick up in 2023. Services activity explained two-thirds of the growth resilience at the beginning of the year. However, we believe it not hold beyond the summer. Firstly, transport services are heavily reliant on goods trade and they will slow down. Other cyclical services such as business services or telecom will contract due to sluggish economic activity. Only travel, which accounts for roughly 10% of services exports, will grow, at least until the end of the summer season. But this will not be enough to prevent a broad-based trade recession.

Figure 4: Global trade in goods and services (%)



Sources: National authorities, Refinitiv Datastream, Allianz Research

Figure 5: Global trade by sector (% y/y)



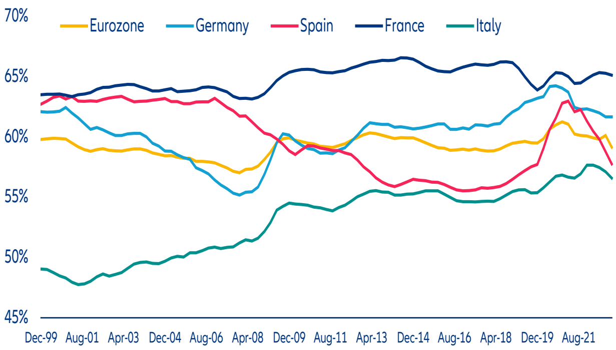
Sources: National authorities, Refinitiv Datastream, Allianz Research

Companies are hoarding labor despite the fall in margins. But this can't last for too long. Global corporate revenues continued to increase in Q1 (+2.7% y/y) albeit much slower than in previous quarters (+4.0% in Q4 and +9.0% in Q3). While restaurants, hotels and airlines still enjoy high pricing power, other sectors such as metals & mining, maritime or semiconductors have seen their demand and prices fall compared to a year ago. Although still negative (-0.1% y/y in Q1 after -4.9% in Q4), the global earnings growth rate was better than expected as companies have been adapting their businesses for a gloomy 2023 via staff rightsizing, restructuring plans and other cost-saving measures. In Europe, a warmer-than-expected winter and continued state support also contributed to lower energy bills. Wage pressures have been somewhat higher in Germany, where rising labor market participation has not helped ease the scarcity of workers in several sectors, including construction. Across the largest Eurozone economies, we expect wages to increase by +4-5% this year, followed by +3.5-4.0% next year. While well-anchored inflation expectations suggest that the risk of an adverse price-wage spiral remains small, it cannot be ruled out. Wage pressures as a percentage of gross value added remain above average in the Eurozone, most notably in France, Germany and Italy. Since other costs excluding wages cannot be reduced indefinitely and pricing power has been fading in most sectors, we see margins squeezing in the coming quarters, increasing pressures on companies that scaled back hiring, but "hoarded" labor amid deteriorating demographic trends and expectations of a short-lived moderate recession.

Disinflation will gain pace, notably for goods and will push real wage growth into positive territory. First, China is exporting deflation at a higher speed, which should support a fast cool-down in goods inflation in the US, the Eurozone and the UK. Producer prices have been falling since last October (-4.6% y/y in May) and price at factory gates prices fell at the fastest pace in seven years. We expect them to remain in negative territory in 2023, given high inventory levels and weak external demand, while inflation should remain at 2.4% y/y, well below the 3% target. Second, energy inflation will continue to be negative until year-end, even if base effects will be lower. Oil prices should increase until the end of 2023 in response to persistent demand and supply uncertainties, averaging USD82 but remaining -15% below 2022 levels compared to -20% currently. A resilient global economy is keeping oil demand strong and the prospect of a positive summer season in the West will also support demand for transportation fuels. While oil prices have declined since the start of the year, short bets are likely to unravel in the coming months as the supply outlook has been shifting, too[1]. Geopolitical developments are adding a layer of complexity, with Russia holding the key to stabilize markets through compliance on its own production targets, and also paving the way to more Saudi exports towards Asia to ease some of the tension between OPEC+.

[1] The US shale industry, a key player in global oil supply, is prioritizing profits over volume. Although crude oil prices are still above the breakeven price for US shale players (estimated at about USD55/bbl), higher interest rates and growing wage bills have led the already highly leveraged sector to focus on profitability. This strategic shift will limit US oil output, thereby widening the supply-demand gap. Meanwhile, Saudi Arabia, the world's leading oil exporter, decided to cut its oil production at the last OPEC+ meeting. This move is a strategic gambit aimed at stabilizing the global oil market and supporting oil prices. Saudi Arabia's commitment to reducing output will deepen the deficit, potentially pushing oil prices higher. But it will also pose risks to the country's market share around the world.

Figure 6: Compensation of employees as a share of gross value added



Sources: Eurostat, Allianz Research

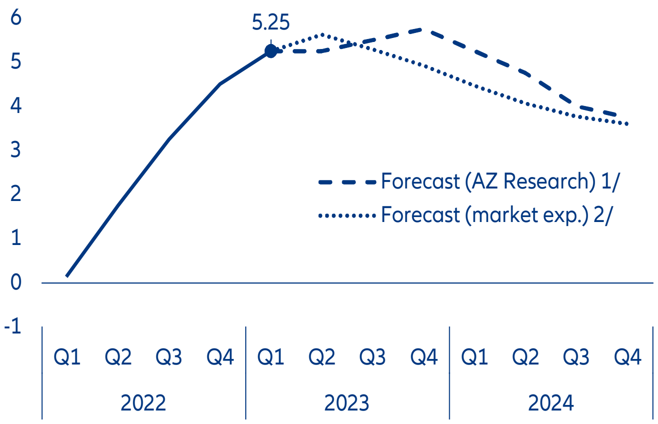
Figure 7: Brent crude oil price forecast (USD/bbl)

Sources: Refinitiv Datastream, Allianz Research

Central banks remain determined to fight inflation, but we expect the hiking cycle to slow over the summer. Given the sticky core inflation, we expect rates in advanced economies to remain at high levels and a less ambitious pivot next year. However, during the second half of the year, the restrictive monetary stance risks becoming increasingly politicized as central bankers are expected to continue prioritizing fighting inflation over supporting growth. This will be the ultimate litmus test for their independence. It will also constrain the pace at which they unwind quantitative easing. The passive run-off of the US Federal Reserve's balance sheet continues to strengthen the restrictive stance but is unlikely to accelerate to prevent further upside pressure on long-term rates. In the Eurozone, the passive run-off of the legacy asset-purchase program from Q3 onwards will quicken the pace of quantitative tightening but the still-limited scope is unlikely to increase the potential of rising fragmentation risk due to a rise of peripheral sovereign spreads.

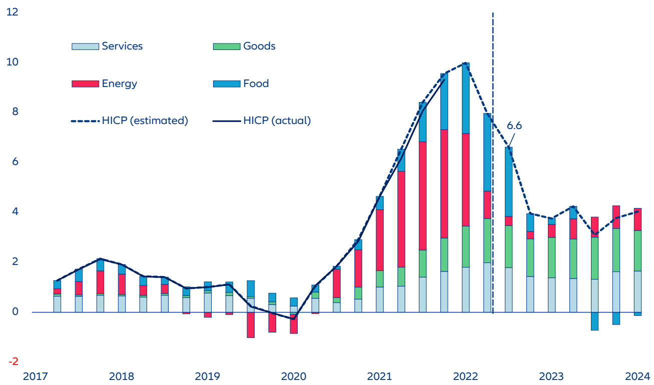
In the US, resilient activity and limited financial stability concerns means tight(er) monetary policy for longer. After pausing in June, we expect the Fed to resume hiking both in July and September by delivering two final 25bps rate increases to reach 5.75% terminal rate as still-elevated wage and price pressures force its hand. Weaker economic momentum should materialize in end 2023-early 2024 while core inflation should slip to around 4% from 5.5% currently. As a result, the Fed will be comfortable enough to ease off on its very tight stance in Q1 2024 by delivering a first rate cut (Figure 8).

Figure 8: US – Federal Funds rate (market expectations and forecast) (%)



Sources: Refinitiv Datastream, Allianz Research

Figure 9: Eurozone – Headline inflation (decomposition)



Sources: Refinitiv Datastream, Allianz Research

Broad price pressures still create a challenging environment for monetary policy in the Eurozone. The drop in headline inflation to 6.1% in May (down from 7.1% in April) was larger than expected due to deflationary energy prices (at -1.7%) and declining food inflation (at 12.5% y/y from 13.5%). More importantly, however, core inflation – the ECB's guidepost for calibrating its monetary stance – declined to 5.3% (down from 5.6%), which was below consensus expectations and marked a four-month low. We expect price pressures, especially for services, to remain strong and elevated during the remainder of the year (Figure 9). With the normalization of inflation more protracted in the Eurozone than in the US, high core inflation will reinforce the ECB Governing Council's conviction that further rate increases are still needed. Services inflation will remain elevated for the remainder of the year, with wages accelerating on the back of continuously robust demand, notably for tourism. Also, the lack of spillover effects from US banking-sector stress means that financial stability concerns will be insufficient for the ECB to abandon its restrictive monetary stance. However, the disappointingly small rebound in German industrial production in April, deteriorating business confidence and stagnant investment suggest that the ECB will need to decide on a policy rate path that does not excessively slow aggregate demand (considering that the impact from rapidly tightening financing conditions operates with considerable lag). Over the medium-term, inflation will remain above the ECB's 2% price-stability target, with headline inflation averaging almost 6% this year and about 3% next year. However, as money supply keeps contracting, it is hard to see a relapse of inflation, even though some bumps along the way of normalizing prices cannot be ruled out (bar any financial sector accidents or potential crisis event) (Figure 10). After the 25bps hike at the last meeting, we forecast two more 25bps hikes in the next ECB policy meetings in July and September, for a terminal rate of 4.0%. This would mean the ECB maintains a restrictive stance in 2023 despite stagnating growth until Q1 2024 (Figures 1014).

Positive real interest rates will push non-payment risk higher and household residential investment lower. About 90% of the pass-through from higher key interest rates materializes after four months, and the full pass-through essentially materializes after seven months. However, high cash balances are providing significant buffers against the monetary policy normalization, so the full pass-through for corporates is likely to be delayed until 2024. The latest figures suggest that corporates' excess cash stands at USD240bn in the US and more than EUR850bn in the Eurozone. This at a time when credit is expected to contract ahead of the peak in bank loan rates late this fall. If interest rates rise by another 200bps, we calculate that the share of fragile SMEs, i.e. companies likely to default in the next four years, would rise to 18% in the UK, 14% in France, 7% in Germany and 10% in Italy (i.e. return to 2019 levels, see Figure 14)[2].

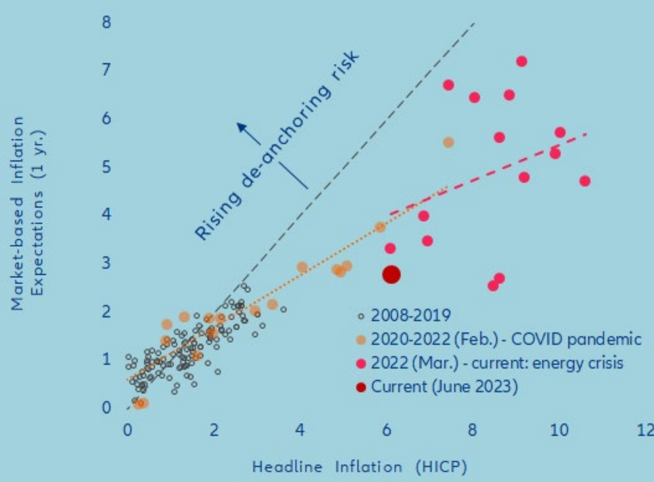
With an average debt/EBITDA ratio of 3.8x, US firms are more leveraged than European ones (3.3x), which implies a greater exposure to increased funding costs. They are also less capable of covering interest payments (EBITDA/int of 3.2x in the US vs 6.4x in Europe). However, European companies have a higher proportion of total debt maturing within one year (20% of total debt vs 14% for the US), which implies less liquidity. Within the non-financial corporate segment, the real estate sector is the most exposed to short-term debt, followed by automotive, which is explained by original equipment manufacturers' captive-finance business that behaves as a bank. When looking at the median levels of total indebtedness and the median ability to meet financial commitments, five sectors stand out as the most exposed to financing stress globally: transportation, construction, hospitality, commodities and automotive. Construction and retail top the watch list in both North America and Western Europe.

Business insolvencies are expected to continue increasing globally (+21% y/y) due to the triple-whammy of lower demand, prolonged pressure on margins and larger financing issues. As of June 2023, the upside trend is well on track for three out of four countries, with several double-digit rebounds in each region. Western Europe (+13% y/y in Q1) is a key contributor to the global rebound, ahead of Central and Eastern Europe (+12%), despite a wide disparity between sectors. This is the result of the uneven exposure to various shocks and uneven support measures (this is particularly the case for transportation/storage, trade and accommodation/food services). The main exceptions to the trend are Russia, China, South Africa and Italy, as well as Spain (a special but temporary case due to strikes at the courts). For now, advanced economies such as Canada, the UK, Denmark, Finland and Switzerland are already seeing business insolvencies above pre-pandemic infra-annual levels, followed by Sweden and Austria. France and Norway should soon join the club. Globally, this should be the case for one out of two countries by end of 2023, with the main exceptions in Asia (China, Japan, Australia, South Korea, Singapore), Latam (Brazil) and the US.

[2] Using our proprietary database and considering a filter for profitability, i.e. ROCE = EBIT / (Net financial debt + equity), capitalization, i.e. equity / total assets and interest coverage, i.e. EBIT/Interest expense, we find that 16% of them are at risk of insolvency in the next four years in the UK, 12% in France and 10% in Italy.

	Germany	France/ Italy	UK
Profitability (ROCE)	7%	6%	7%
Capitalization	20.60%	23.20%	21.90%
Interest coverage	0.8	1.1	0.9

Figure 10: Eurozone – Headline inflation and inflation expectations

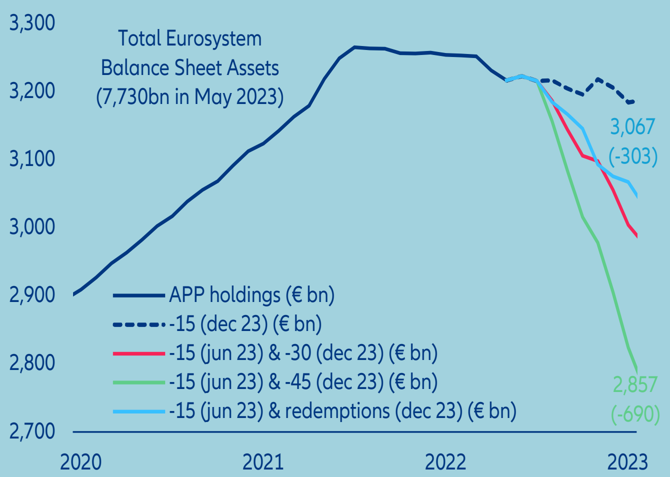


Sources: Refinitiv Datastream, Allianz Research

Figure 11: Eurozone – ECB deposit facility rate (market expectations and forecast) (%)

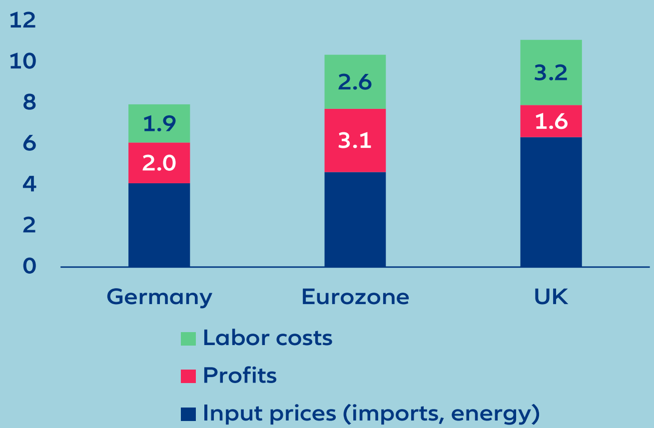
Sources: Refinitiv Datastream, Allianz Research

Figure 12: Eurozone – Projection of Eurosystem legacy asset purchase program (PSPP) balance (EUR bn)



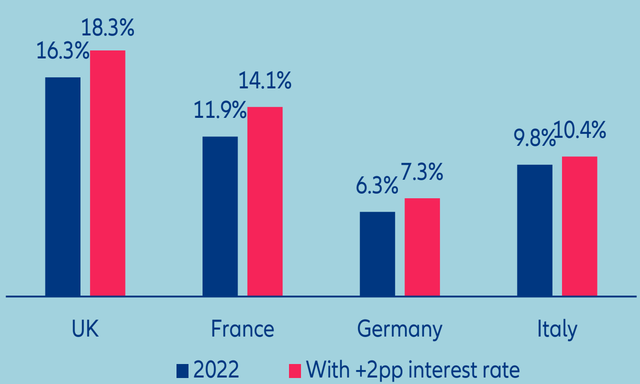
Sources: Refinitiv Datastream, Allianz Research

Figure 13: Eurozone – inflation drivers (GDP deflator components)



Sources: Refinitiv Datastream, Allianz Research

Figure 14: Share of fragile SMEs in selected countries



Sources: Refinitiv Datastream, Allianz Research

Figure 15: Business insolvencies y/y change in %

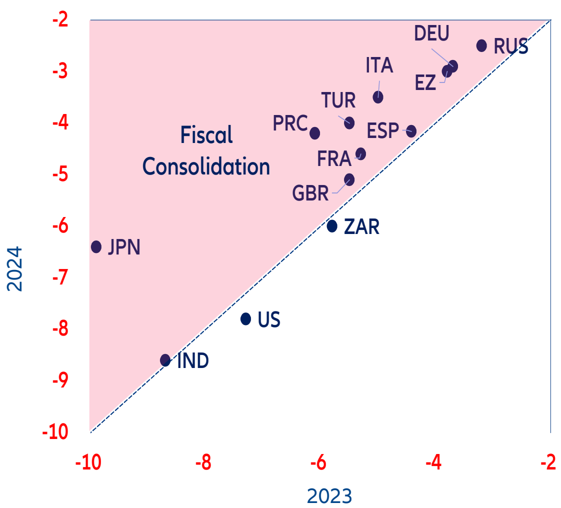
	Industry	Construction	Trade	Transport & storage	Accommod. & food service activities	Information & communic.	Finance, insurance, real estate, B2B activities	Education, human health and social work activities
Belgium	10	24	1	-4	21	-11	7	18
Bulgaria	-19	14	-6	-29	-7	69	-2	-42
Croatia	-27	-8	-13	1	-18	-5	-20	-25
Denmark	-4	29	4	-5	17	-32	-28	-35
France	63	43	43	30	61	51	37	35
Germany	13	11	33	3	14	27	8	26
Hungary	144	227	264	115	337	324	252	308
Iceland	250	191	216	350	123	227	122	225
Italy	4	-15	-2	-16	-25	23	8	5
Lithuania	10	-28	60	-52	28	-31	4	-29
Luxembourg	-20	111	4	38	124	-45	4	-33
Netherlands	175	16	79	111	187	50	26	-21
Norway	25	31	67	7	104	17	27	38
Poland	62	-12	146	-86	80	-29	92	100
Portugal	15	73	26	12	-3	0	11	48
Romania	3	5	4	-4	-15	0	-17	-22
Slovakia	5	-7	-5	25	33	0	-7	-40
Slovenia	13	9	-42	0	73	0	17	-62
Spain	5	-14	19	70	35	-8	17	69
UK	19	1	35	8	44	-12	-4	21

Note: non seasonally adjusted numbers; underligned figures indicate a higher number compared to 2019 average; German figures refer to December 2022 / February 2023 period.
Sources: National sources, Eurostat, Allianz Research

Prepare for fiscal consolidation next year. The scale of discretionary fiscal spending to cushion the impact of the energy crisis on firms and households remains high. Even though energy prices have fallen back to their pre-war levels, governments continue to spend generously on energy-related measures. In Europe, measures aimed at fighting the cost-of-living crisis will still amount to 1.2% of GDP this year (one-third of the fiscal support since September 2021). Unsurprisingly, the fiscal response remains higher in countries with larger energy-intensive industries and/or greater gas dependence. Non-energy-related measures are likely to accumulate into a deterioration of the structural balance by around 0.3% of GDP. In the US, fiscal policy has eased in 2023 as effective personal income rates were cut back (from a historically elevated level) and Social Security payments shot up to make up for high inflation.

While the fiscal stance remains accommodative, fiscal consolidation will start in earnest next year as rising interest rates restrict room for maneuver. In Europe, the cyclically adjusted fiscal spending (relative to GDP), a proxy for the fiscal stance, is still near record highs even though the case for fiscal accommodation has weakened as the economy is close to full potential, and even though it could jeopardize the ECB's inflation-fighting

Figure 16: Projected fiscal balance (% of GDP)



Sources: Refinitiv Datastream, Allianz Research

due to prolonged aggregate demand support. Since the structural deficit, including energy-related measures, will decline by about -0.5% of GDP this year, and thus lower GDP growth by roughly the same amount, the cyclical impact of a more restrictive fiscal policy will not be large despite subdued growth. Diminishing fiscal space could require difficult policy trade-offs as governments need to also tackle important structural challenges in the wake of the recent crises, such as the green transition and important pension and tax reforms. In the US, the debt-ceiling agreement struck between the White House and Congress Republicans entails spending caps. But they are narrowly focused on federal non-defense discretionary spending only, which will limit the extent to which fiscal policy will be tightened. Nevertheless, fiscal consolidation should accelerate in US states amid a rapidly growing interest bill and expected cutbacks in federal transfers. We expect a negative general government (GG) fiscal impulse to the tune of 0.7% of GDP in 2024, but we project the GG fiscal deficit to widen to -7.8% of GDP (after -7.3% in 2023) amid a Fed-induced weaker economy and a rise of interest payments above 4% of GDP.

The remainder of the year and next year will see a full calendar of elections in countries accounting for close to three-quarters of global GDP, including Austria, EU, India, Mexico, Poland, Romania, Russia, South Africa, Taiwan, the UK and the US.

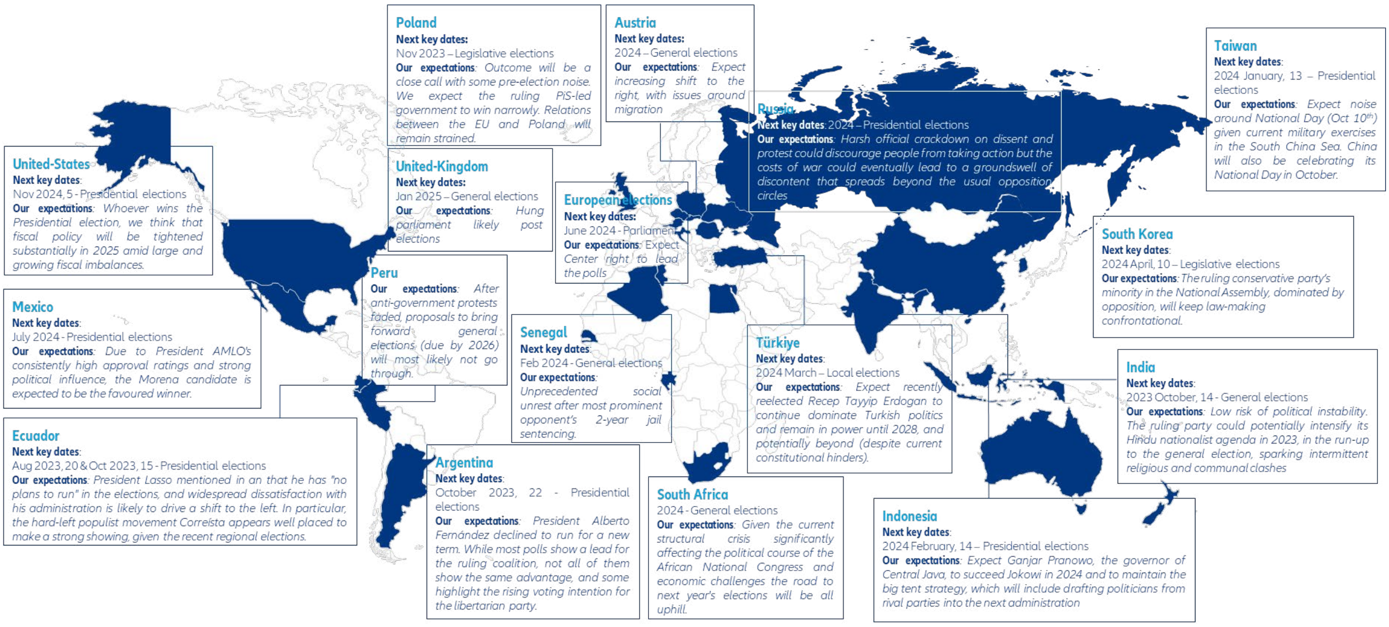
The general elections in Spain at the end of July and in Poland in fall will be critical for the EU's ambitious agenda, and a litmus test for the EU Parliament elections next year. In Poland, the election will decide on both chambers of parliament, the Sejm and the Senate. However, tensions with other EU member countries are already running high after the European Commission decided to withhold the second tranche of Recovery and Resilience Plan (RRP) disbursements under the Next Generation EU recovery plan after the Polish authorities challenged the European Court of Justice's assessment of its controversial judicial reforms. At the same time, Poland has been (and remains) the main staging ground and logistical hub for EU and Western support for the campaign in Ukraine, which makes the country a vital strategic partner for Europe's security interests. The opposition parties see this as a chance to vote out the PiS-led national conservative government, and the possibility of a change in power has increased in recent months. Yet, the PiS-led coalition continues to lead in polls and we expect it to win narrowly.

After the regional and municipal elections in May, Spain will go to the polls in July. The vote is likely to confirm the conservative shift in public sentiment. Since Spain's center-right Citizens party, once seen as a potential kingmaker, has announced it will not run in the general election after an abysmal performance in the regional and municipal elections, the path for the triumphant conservative People's party (PP) seems clear, with current government parties achieving only 28.7% of the votes, according to recent polls.

The US presidential election will be held in November 2024. Incumbent President Biden is seeking re-election for a second term in the White House. His Republican challenger will be picked in Spring 2024 during the party's presidential primaries. Former President Trump is the lead frontrunner but the Florida Governor Ron DeSantis is also a serious contender. Whoever wins the Presidential election, we think that fiscal policy will be tightened substantially in 2025 amid large and growing fiscal imbalances.

In the UK, general elections need to be held at the latest by the end of January 2025. Half the population expects early elections by end-2023, with 46% expecting Sunak to no longer be PM, and 27% expecting Starmer to be elected instead. A hung Parliament is likely post elections even if a labor-led majority cannot be excluded. Their main electoral pledges are: (i) scrapping the non-dom tax loophole; (ii) the wealth tax; (iii) a tax of 1% or 2% a year on any property worth over GBP1mn and (iv) a VAT hike on private schools. LibDems could join the majority under the conditions of getting closer to the EU and reforming the UK voting system from "first past the post" to proportional representativity.

Figure 17: Upcoming elections



Sources: Allianz Research, Economist Intelligence Unit

Social fatigue across emerging markets is likely to unfold amid a general convergence towards lower growth rates on the back of decelerating commodity prices, a higher USD, rising liquidity strains and delayed rate pivots. Divergence among EM countries will also remain high. Recent PMI figures showed a rise in activity prospects in Asia (excluding China) but they remained relatively weak in Europe and Latin America. Inflation is trending lower but as the USD appreciates, the majority of central banks will remain restrictive, delaying rate pivots to late 2023 or early 2024 in major EMs in Latin America, Europe and Asia. In most African countries that are still facing imported inflation and spiralling currency depreciation, as well as the GCC, where fiscal space reduces in tandem with lower oil revenues, the pivot could be delayed to 2024. In Central and Eastern Europe, the absorption of NGEU funds will provide an additional cushion and some fiscal stimulus, mitigating the downturn and preventing a region-wide stagnation.

Latin America is a mixed bag. Economic activity has surprised on the upside, with upward revisions to economic growth in the region's main economies (with the exception of drought-hit Argentina). However, we expect growth to slow due to the lagged effects of extremely tight monetary policy. The speed of the adjustment depends on idiosyncratic factors. We see pockets of resilience in Brazil and Mexico, which have tighter labor markets (Mexico is also seeing significant wage growth), while in the Andean countries – Colombia and Chile – an adjustment already seems to be underway. The drop in global liquidity is creating volatility in countries with high debt redemptions in the short term.

Africa will remain at the forefront on debt sustainability and several IMF programs will prove difficult to implement while negotiations with creditors and growing insecurity in the continent have already postponed the full economic recovery to 2024. In Asia, there will be a limited positive growth impulse from China, while advanced economies provide only constrained support to exports.

Table 1: Key challenges for emerging markets

Emerging Asia, excluding China	Growth in Emerging Asia excl. China to slow to +5.7% in 2023 after +5.9% in 2022. This compares with an average of +8.0% in the 2010s. The forecast for 2024 is +6%. Economies exposed to exports and cyclical sectors (e.g. South Korea, Taiwan) are likely to see a relatively bigger step down in growth. They are also subject to downside factors affecting most of the region, e.g. elevated interest rates and inflation (albeit lower than in other regions). Domestic demand has turned a corner in almost all markets and is set to slow (India and Indonesia slightly more resilient). Balance-of-payment risk is lower than in other regions of the world, with Malaysia, Indonesia and the Philippines relatively more exposed among major economies of Emerging Asia. Pakistan and Sri Lanka will only slowly leave behind the debt concerns that emerged in 2022. Important elections are scheduled in 2024: Taiwan (January), Indonesia (February), South Korea (April) and India (May). Geopolitical tensions, notably under the shadow of US-China tensions, will continue (though an outright conflict is unlikely).
Emerging Europe	Stagflation fears are largely off the cards now – except for Czechia, Hungary and the Baltics – yet growth in Emerging Europe excluding Russia and Ukraine will markedly decelerate to +2% in 2023 from +4.5% in 2022, before picking up to +3% in 2024. Inflation is gradually retreating but remains sticky and on average in double digits in most countries in 2023. Inflation targets will not be reached before 2025. Limited monetary and fiscal policy space challenges CEE policymakers to find the right policy mix and good policy communication: * Large twin deficits call for tight monetary and fiscal policy stances in 2023 and 2024. * Tighter global liquidity conditions, along with sticky inflation, rapid wage growth as well as the potential for renewed currency volatility in the region require continued tight monetary policy as well. * Public finances are still stretched from measures to cope with the pandemic while financing costs have increased. In EU member states, however, NGEU funds absorption will provide some fiscal support. A balance-of-payments crisis continues to loom in Hungary and Romania, and remains in place in Turkey. Risks of an energy crisis in winter 2023/2024 have declined but cannot be ruled out in the event of a very cold winter. Crucial elections are scheduled in Poland (November 2023, legislative), Romania (end-2024, general) and Turkey (March 2024 local), providing room for policy mistakes in the run-up to the polls. General elections in Turkey in May 2023 did not bring about any changes and early post-election signals of a shift to more orthodox economic policies should be taken with caution.
Latin America	Stronger-than-expected economic activity in the first quarter has led to significant upward revisions to economic growth in the region's major countries, with Argentina remaining a notable exception. Nevertheless, economic growth in 2023 is expected to be significantly weaker than last year. Inflation has moderated significantly, but is expected to remain above the main central banks' target until 2024. This, together with a change in US monetary policy (no MP pivot until the end of the year, soft landing), leaves a small window for significant rate cuts within the region. Chile appear best positioned to begin a (limited) easing cycle, followed by Brazil, while Mexico is unlikely to cut rates until 2024. Carry should continue to play a key role in the region. Latin American currencies have been the best performers against the USD this year. High interest rates, resilient economic growth and a better outlook for the US position Mexico and Brazil (which has also undergone important macroeconomic reforms such as the new fiscal framework) as two countries that can benefit from the current environment.
Africa and the Middle East	Several economies continue to grapple with a cost-of-living crisis due to limited food supply options, prolonged drought and distorted energy markets, combined with thin fiscal and monetary options and increased insecurity. At the same time, IMF-led support programs are finally getting off the ground with Morocco (without conditionality), Côte d'Ivoire, Ghana and Kenya among the first to be able to access new funds. Inflation rates remain slightly above 11% on average across the African continent, with growing tensions between institutions (e.g. central bank and government) in Nigeria and South Africa and greater exchange rate volatility in countries where the central bank is less independent (e.g. Egypt, Angola, Nigeria). These ups and downs continue to affect the business environment and put the financial strength of public and private counterparts at risk. The Middle East is in a phase of conflict stabilization and reinforced regional cohesion, with Saudi Arabia the main driving force and Israel the most notable exception. Gulf economies are expected to experience durable though moderated growth in 2023, with Saudi Arabia and Iraq leading the way. Oil prices remain broadly supportive, even though the pivoting of central banks in AEs amid lower oil revenues and the need to maintain the peg with the USD could water down the effect of domestic monetary policy, leaving the UAE and Saudi Arabia in particular with a higher-than-expected inflation rate in 2024 and less conducive credit conditions.

Source: Allianz Research

Much of the economic boost from China's reopening has already happened, with better downstream sector performance than upstream ones. Pent-up demand amounts to 4.5% of GDP, but less than 40% is likely to be released in 2023, which will limit GDP growth to +5.8% in 2023 (+4.5% in 2024). Based on previous reopening experiences, the largest impulse from pent-up demand this time around is likely to be felt in the first half of this year. The boost to consumer spending could ultimately prove to be smaller than in the post-2020 experience, given the current less favorable domestic and external macroeconomic conditions. We note already that consumer spending this time around seems so far supported by revenge spending in catering, while spending on discretionary goods is not performing as well as it did in the post-2020 period.

The growth story will remain focused on consumption, though it is likely to be mostly domestic (i.e. firms operating in China benefiting more than those exporting to China). We see a continued soft industrial sector, which will weigh on global trade of goods, already in recession since last November. We continue to think that structural issues (e.g. the real estate sector and youth unemployment, which surpassed 20% in April) mean that consumer spending will take longer to approach its pre-pandemic trend than in 2021. The saving rate remains above the pre-pandemic average of 29.1% and we doubt that Chinese households will dig into the relatively small stash of excess savings accumulated during lockdown periods to fund consumption. Indeed, we estimate that excess savings accumulated in 2020 and 2022 amount to only 2.7% of 2023 nominal GDP. Furthermore, in 2021, the year of the post-Covid consumer rebound, the decline in savings amounted to just 3.6% of 2020's excess savings.

We believe Chinese authorities will implement further targeted fiscal stimulus while further cutting down key interest rates. Recent measures on property easing are a good example: property sales fell and developer credit risks re-emerged in May, requiring further actions from policymakers to ensure stabilization and continued recovery. Financial strains are easing, thanks to increased policy support for real estate developers and a broader improvement in economic conditions. But the property sector remains a key vulnerability as does local government debt. The State Council's latest announcement that it will increase support for electric vehicles is another example of moderate and targeted stimulus. Finally, on the monetary side, the credit impulse is half of what it used to be last year and shadow banking is three times more compared to past years. Hence, we cannot exclude further rate cuts after the -10bp implemented in June. We expect a tax cliff for corporates as several tax rebates/ deferrals from the government to corporates received earlier last year need to pe repaid by year-end. The non-performing loan (NPL) ratio is likely to have increased from 2% to above 7% considering the PBoC 2021 stress tests key assumptions.

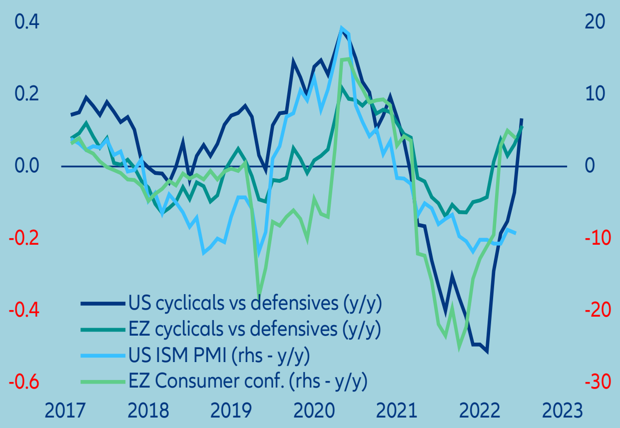
Globally, the balance of risks remains tilted to the downside. Even though the US banking crisis has been effectively contained and did not trigger greater dislocations in capital markets, further bank failures and potential spillover effects to the rest of the world cannot be ruled out as policymakers struggle to restore investor confidence amid tightening credit conditions. Potential bailouts of bankers and tech start-ups might also have political implications in the run-up to the 2024 US Presidential campaign. Higher-for-longer inflation also increases the risks of a policy mistake by central banks, which will need to maintain a more restrictive monetary stance. US monetary tightening and overshooting particularly by the Fed could prolong the current economic downturn and delay the recovery. Renewed energy supply constraints in Europe, for instance as a result of a cold winter in 2023-24, could also bring back the specter of gas rationing and push real growth in most countries into negative territory until mid-2024. However, a ceasefire between Russia and Ukraine would help reduce much of the prevailing uncertainty about the outlook and would allow for resources to be allocated more efficiently, including through strengthening strategic trade relationships that are currently under strain but critical to tackling important secular challenges (slowing globalization, rapid digitalization and effective de-carbonization). A more globally oriented reopening of China's economy could also revitalize flagging global trade and accelerate the normalization of inflation. stagnation.

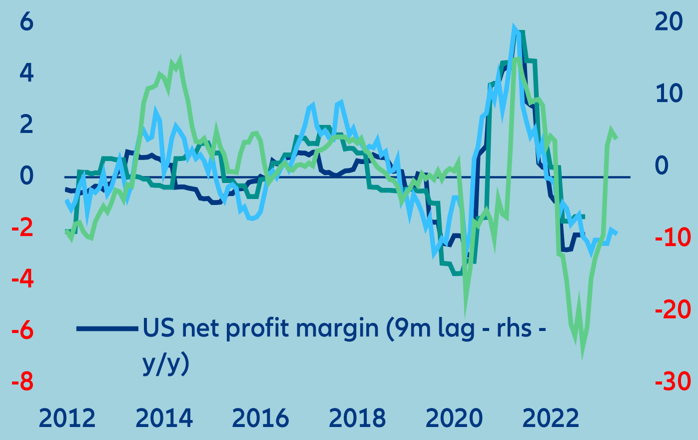
Capital markets – playing the waiting game

On the heels of last year's disastrous performance, capital markets have remained in a holding pattern during the first quarter of the year. However, the prospect of central banks reaching their terminal rates, contained stress in the banking sector and resilient corporate earnings despite shallow growth have supported asset prices. Yet, persistent stress in the US banking sector, rising fragmentation of capital flows and uncertainty around the future shape of the economic slowdown will continue to weigh on investor appetite until the end of the year. As quantitative tightening drains excess liquidity, relapses of money market stress and elevated funding liquidity risk are likely to reoccur; fundamental valuations will remain under scrutiny and volatility around market assets will remain high.

Equity markets have defied the gravity of poor economic conditions. The unexpectedly positive market performance year-to-date has exceeded analyst estimates due to better-than-expected Q1 earnings, lower downside risks of a US recession and positive political news flow. However, the rally is bound to lose steam against the background of lackluster growth and higher-for-longer short-term rates due to the protracted normalization of inflation. Regional divergences might also arise during the year. In the US, the divergence between economic leading indicators and current market pricing is rather extreme, especially since the former is struggling to revert its downside trend. However, in the case of the Eurozone, current market performance seems consistent with incipient economic optimism (Figure 17). Nonetheless, here as well economic indicators suggest a drop in corporate margins before a rebound later in 2024, which will keep valuations range-bound (Figure 18). Despite the better-than-expected Q1 earnings season, we expect EPS growth to disappoint this year as both revenues and margins are likely to contract further before rebounding next year. Our macro-based EPS models show similar results for both US and Eurozone equities (Figure 19 and 20). This should deter investors and put downward pressure on valuations during the second half of the year.

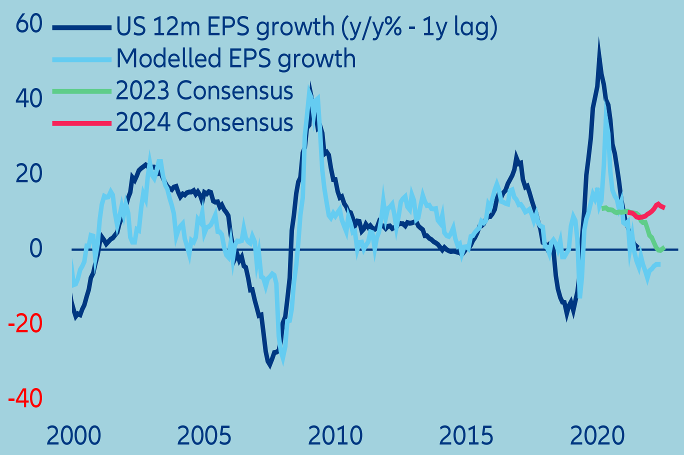
Figures 17 and 18: Equity performance and margins vs economic leading indicators

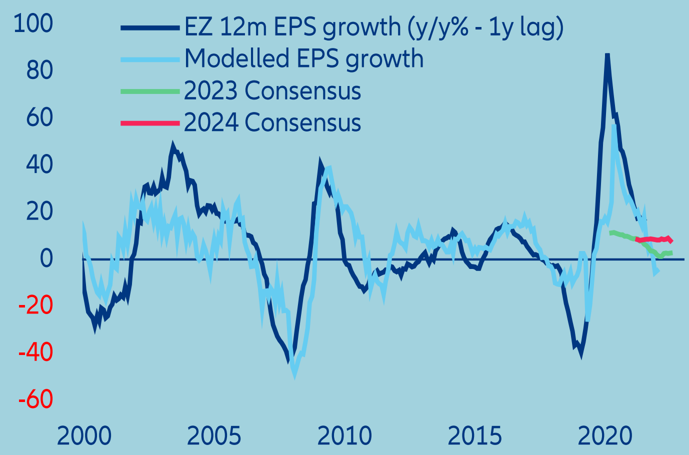




Sources: Refinitiv Datastream, Allianz Research

Figures 19 and 20: EPS models





Sources: Refinitiv Datastream, Allianz Research

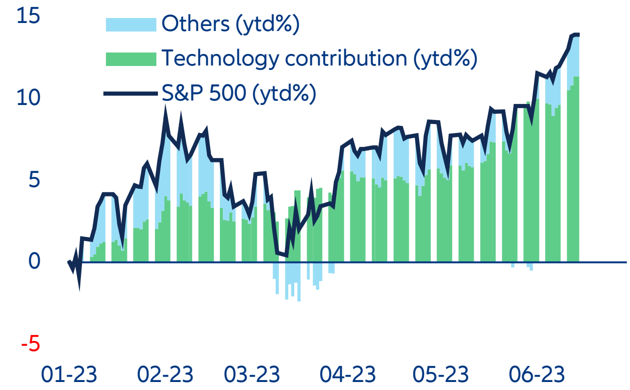
Sources: Refinitiv Datastream, Allianz Research

We are bearish on equities but continue to expect positive returns in 2023: around 6-9% for the US and Eurozone. We expect similar numbers in 2024 as market participants are likely to front-run some of the expected 2024 optimism before year-end, especially if central banks refrain from tightening financial conditions further. As depicted by our estimates and regionally, we continue to expect the US to underperform the Eurozone as fundamentals, technical and valuations, as well as concentration risk, point to much higher downside risk for US equities. Only around a handful of technology mega-caps account for most of the recent market rally. However, European equities looks far more diversified and slightly more defensive, thus exhibiting an ex-ante higher degree of resilience vis-a-vis possible hiccups down the line (Figure 21).

No reward for risk – equities continue to look expensive, even from a cross-asset perspective. Equities are expected to underperform relative to fixed income instruments in terms of equity risk premium, risk-adjusted return or just by comparing dividend yields to fixed income yields (Figure 22).

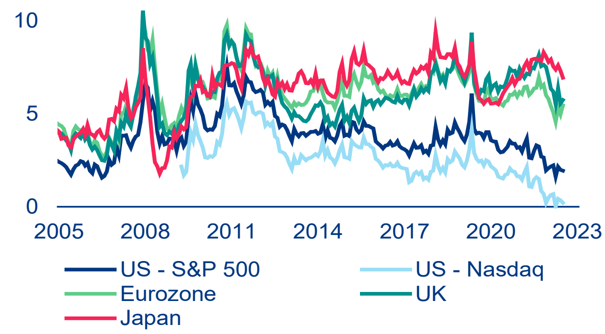
Uncertainty about the policy rate path and rates volatility remain too high to lengthen duration just yet. Upward revisions in monetary policy expectations and better-than-anticipated economic resilience pose upside risks for long-term yields over the short run. Dependencies across yield curve maturities also remain exceptionally high, leaving the long end of yield curves at the mercy of changes in both the realized and expected policy path. Considering our upward revision of the growth outlook for both the US and Eurozone, our monetary policy forecast diverges on the upside from the market pricing until the end of 2024. Consequently, we anticipate ongoing upward risks for long-term yields in the short run as the market adjusts to central banks' revised landing levels (Figure 23 and 24).

Figure 21: US equity markets year to date performance decomposition



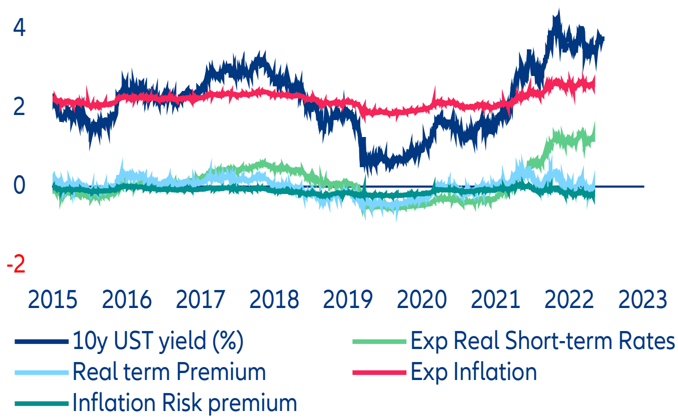
Sources: Refinitiv Datastream, Allianz Research

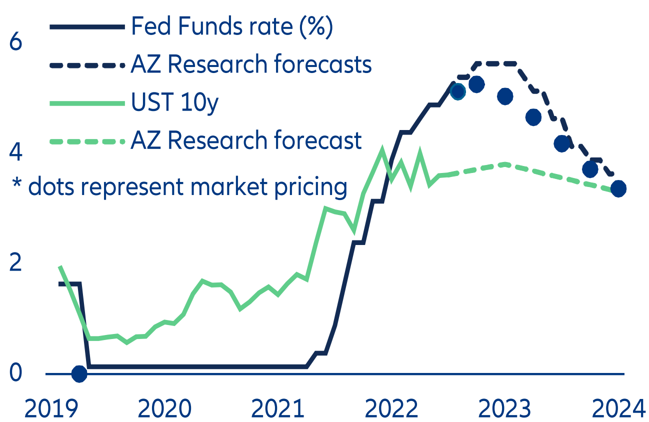
Figure 22: Equity Risk Premiums (% and bps)



Sources: Refinitiv Datastream, Allianz Research

Figures 23 and 24: 10y UST decomposition / Fed Fund rates and UST 10y forecasts



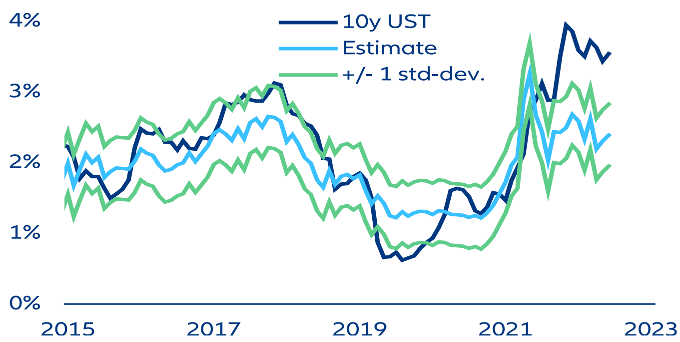


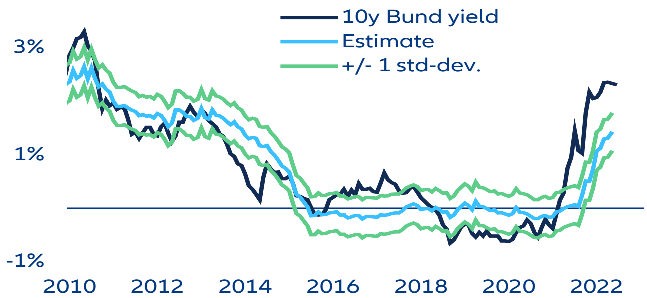
Sources: Refinitiv Datastream, Allianz Research

However, we expect a slow decline of long-term rates over the medium term. Fair valuation paired with weak economic momentum will push long-term yields down slowly but steadily over the forecasting horizon, especially after central banks have reached the terminal policy rates of the current hiking cycle. We anticipate the 10y yield for US Treasuries to settle around 3.8% by the end of 2023? and to drive towards 3.3% in 2024. We forecast a similar pattern for the 10y Bund? with yields finishing 2023 close to the 2.5% mark, and to converge towards 2.2% in 2024 (Figure 25 and 26).

European sovereign spreads will remain contained but the run-off of the ECB's balance sheet could cause volatility going forward. Since the beginning of the Covid-19 pandemic, the ECB has played a major funding role for Italy and Spain, acting as a source of permanent demand for their respective mid- and long-term bonds. Now, with the ECB stepping back from quantitative easing, and the rotation to private sector demand, we expect the intrinsic volatility in the long end of both curves to be structurally higher moving forward (Figure 27). In the case of Italy, political uncertainty may lead to short-term volatility, pushing the 10y BTP spread above 200bps for a short period of time irrespective of the ECBs unwinding path. We expect similar volatility risk for Spanish spreads after the call for new elections this summer. Nonetheless, Italian 10y BTP spreads should come in at around 190bps at the end of 2023 and contract to 170bps in 2024. The 10y Spanish bono could finish 2023 as low as 100bps, before contracting to 90bps next year.

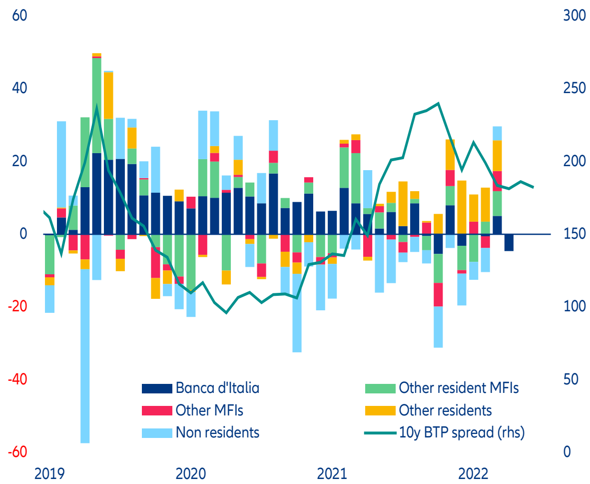
Figures 25 and 26: Long-term yield models (in %)





Sources: Refinitiv Datastream, Allianz Research

Figure 27: Italian debt ownership and PSPP (EUR bn)



Sources: Banca d'Italia, ECB, Refinitiv Datastream, Allianz Research.
Note: PSPP=public sector securities purchase program.

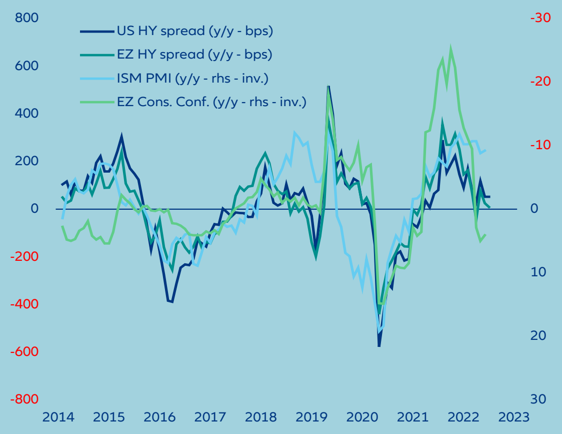
We think that current corporate spreads understate expected credit risk. We anticipate a further deterioration of debt-servicing capacity due to tightening financing conditions. Against the background of low economic growth, more businesses will face difficulties in meeting debt obligations and generating sufficient cash flow. While larger, well-rated companies are likely to withstand these challenges and display resilience, smaller, lower-rated companies will struggle as banks (the main source of finance) tighten underwriting standards and market access has become exceedingly expensive. Thus, we see a fundamental market mispricing, especially in the case of the US and within the high-yield segment. Corporate credit spreads remain relatively tight – and have tightened further with the recent equity rally – despite the negative growth outlook (Figure 28).

We expect widening waves until central banks reach their cruising altitude and start reverting to lower policy rate levels. We expect investment-grade corporate spreads to remain relatively resilient to those widening sprees but to structurally widen on the back of deteriorating balance sheets and accelerating default rates to 150bps (US) and 170bps (EUR) by the end of 2023. In 2024, cheaper refinancing should lead to a spread compression between 20-30bps. In the case of high yield, we continue to expect a widening of between 40-50bps from current levels (440-450bps) for both US and EUR credit. However, we expect a compression of between 50-75bps as the cycle advances. Regionally, we continue to prefer European issuers over US peers (Figure 28).

Delayed policy rate cuts in 2024 could trigger unwanted credit-spread widening. The Fed and the ECB have not reached the landing altitude for policy rates and seem to keep pushing back the beginning of the rate-cutting cycle. Since investment-grade corporates will have significant refinancing needs in 2024 and 2025, higher-for-longer rates will lead to a sharp rise in debt-service costs. However, refinancing pressure for high-yield companies will hit only in 2025 when policy rates should already be at a much more comfortable level (Figure 29).

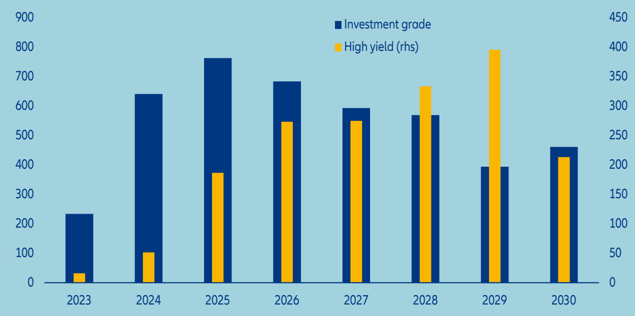
Major EM countries benefited from net positive portfolio inflows during the first half of the year. For debt flows, the situation is not as good as it was at the beginning of the year as the Fed maintains a restrictive stance, challenging carry returns in many EMs. But they continue to be positive, with the exception of Africa and the significant case of China, from where investors have continued to pull money almost non-stop since the policy crunches of 2021. In equities, Taiwan and South Korea have been the real beneficiaries from the optimism around China, and India is gaining traction after the January turmoil. Going forward, we expect capital flows to remain volatile in both directions over the near term.

Figure 28: Cross region credit comparison



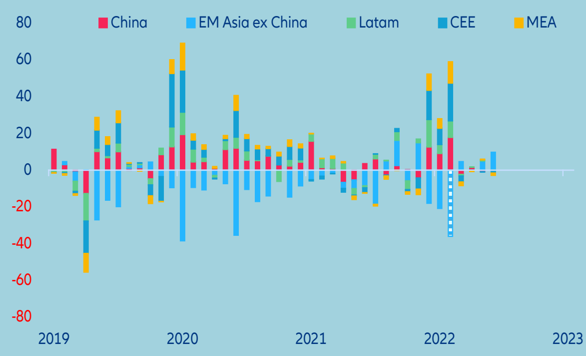
Sources: Refinitiv Datastream, Allianz Research.

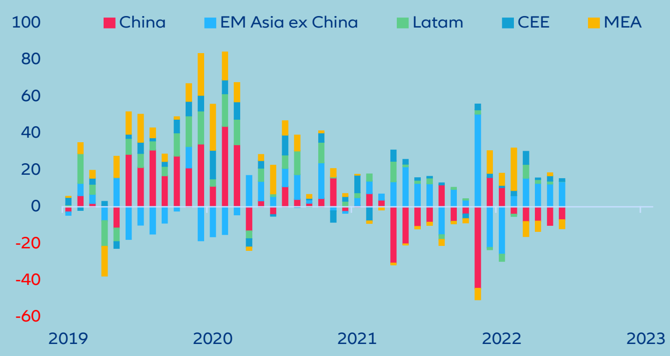
Figure 29: US corporate credit maturity wall



Sources: Refinitiv Eikon, Allianz Research
Note: only rated bonds with a maturity up to 2030 are included.

Figure 30: Net foreign portfolio flows by region, in USDbn.





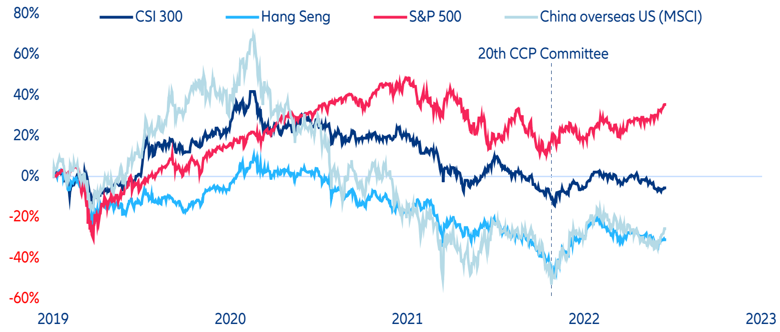
Sources: IIF, Allianz Research.
Note: January 2023 equity outflows from EM Asia ex-China show a huge variation between the IIF reported number for the region (-USD35bn outflows) and the individual outflows from the three major markets (India, Korea and Taiwan reported an aggregated figure of +USD8.5bn in inflows). In January, the controversy over the Adani group in India caused massive outflows, but the figures will probably change once the official number is reported.

Carry trade factor should continue to play an important role for currencies. The reopening of China's economy boosted market sentiment at the end of last year and in early 2023, favoring EMs. Currencies in the high-yielding Latam bloc have been in the spotlight, with MXN, COP and BRL among the year's best performers against the USD (Figure 31). Looking ahead, the scenario may be somewhat more challenging as the world's major central banks - notably the Fed and the ECB - maintain a hawkish tone for longer than previously expected, and as China struggles to maintain momentum in economic growth after the euphoria of the post-Covid reopening. In this environment, idiosyncratic factors will play a bigger role and selection will be key. We are constructive on Mexico and Brazil, given their high interest rates and resilient activity. Mexico is more exposed to the US and continues to benefit from nearshoring, while Brazil should benefit from progress on domestic issues such as the new fiscal rule and likely tax reform. However, plans to change Brazil central bank inflation target could bring volatility to the markets. In contrast, we are more neutral/negative on Chile, which is more exposed to global growth risks, as well as Egypt and South Africa, which are particularly exposed to external shocks and tighter capital inflows.

Recovering growth momentum to create opportunities in EM sovereigns. As economies have been more resilient than expected, this looks like a good moment to invest particularly in EM local currency (LC) bonds. In particular, Latin American countries have recorded positive real interest rates for a while, providing attractive carry, especially as inflation abates. Also, the first rate cuts are in sight this year in Brazil and Chile (as well as several countries in Emerging Europe). For hard currency (HC) bonds, spreads are tight and we expect a slight widening towards year-end. With a long-term perspective and looking only hard currency yields, the situation remains attractive, albeit with some volatility in the next 18 months.

Geopolitics will continue to dampen reopening optimism on China equities, limiting the upside potential for EM equity. The first half of the year saw the abrupt end of the Chinese reopening optimism, in contrast with the equity rally seen across much of the world (see Figure 32). In other EMs, markets that are highly correlated with the US (Taiwan and South Korea due to the technological weight on the indexes, or Mexico) have outperformed the rest. Like in the US, we expect some correction in the course of this year but keep our return forecast of above 10%. We are downbeat on the prospect of markets in Asia recovering without a fundamental change in the position of China. Equities of commodity exporters (mainly Latin America but also Indonesia) should generate returns within the 5-10% range. As an aggregate, EM performance should be positive but lower than that of the US.

Figure 32: Compared performance of different Chinese equity indices (changes vs. 31 December 2019)



Sources: Refinitiv Datastream, Allianz Research.

Table 2: Capital market forecasts

year-end figures	Last	Unit			Baseline	
EMU			**2021**	**2022**	**2023f**	**2024f**
Government Debt						
Policy rate (ECB deposit rate)	3.50	%	-0.50	2.00	4.00	3.50
Policy Rate (MRO)	4.00	%	0.00	2.50	4.50	4.00
10y yield (Bunds)	2.51	%	-0.2	2.6	2.50	2.20
10y EUR swap rate	3.03	%	0.3	3.1	2.80	2.50
Italy 10y sovereign spread	164	bps	136	213	190	170
France 10y sovereign spread	52	bps	37	55	40	30
Spain 10y sovereign spread	94	bps	77	109	100	90
Corporate Debt						
Investment grade credit spreads	158	bps	98	166	170	140
High-yield credit spreads	430	bps	331	494	500	425
Equity						
Eurostoxx (total return p.a.)	15.1 ytd	%	23.4	-12	9	7
US			**2021**	**2022**	**2023f**	**2024f**
Government Debt						
Policy rate (upper)	5.25	%	0.25	4.50	5.75	3.75
10y yield (Treasuries)	3.72	%	1.5	3.83	3.80	3.30
Corporate Debt						
Investment grade credit spreads	137	bps	98	138	150	130
High-yield credit spreads	421	bps	310	479	475	430
Equity						
S&P 500 (total return p.a.)	16.2 ytd	%	28.7	-18	6	9
UK			**2021**	**2022**	**2023f**	**2024f**
Government Debt						
Policy rate	4.50	%	0.25	3.50	5.50	4.50
10y yield sovereign (Gilt)	4.38	%	1.0	3.7	4.00	3.50
Corporate Debt						
Investment grade credit spreads	168	bps	115	192	180	170
High-yield credit spreads	544	bps	390	663	625	575
Equity						
FTSE 100 (total return p.a.)	4.5 ytd	%	18.4	5	3	7
Emerging Markets			**2021**	**2022**	**2023f**	**2024f**
Government Debt						
Hard currency spread (vs USD)	276	bps	295	270	320	280
Local currency yield	6.3	%	5.72	6.50	6.4	5.8
Equity						
MSCI EM (total return p.a. in USD)	8.3 ytd	%	-2.2	-19.7	5	6
Others			**2021**	**2022**	**2023f**	**2024f**
Foreign Exchange						
EURUSD	1.091	$ per €	1.137	1.067	1.10	1.15
Commodities						
Oil Brent*	76	$ per Bbl	78	85	82	86
Natural Gas Dutch TTF*	42	€ per MWh	69	74	50	43

*yearly averages

Source:Allianz Research

Our team

Chief Economist
Allianz SE

Ludovic Subran
ludovic.subran@allianz.com

Head of
Economic Research
Allianz Trade

Ana Boata
ana.boata@allianz-trade.com

Head of Macro and
Capital Markets Research
Allianz SE

Andreas Jobst
andreas.jobst@allianz.com

Head of Insurance, Wealth
and Trends Research
Allianz SE

Arne Holzhausen
arne.holzhausen@allianz.com

Macroeconomic Research

Maxime Darmet
Senior Economist for US and France
maxime.darmet@allianz-trade.com

Roberta Fortes
Senior Economist for Ibero-Latin America
roberta.fortes@allianz-trade.com

Jasmin Gröschl
Senior Economist for Europe
jasmin.groeschl@allianz.com

Françoise Huang
Senior Economist for Asia Pacific
francoise.huang@allianz-trade.com

Maddalena Martini
Economist for Italy & Greece
maddalena.martini@allianz.com

Luca Moneta
Senior Economist for Africa and Middle East
luca.moneta@allianz-trade.com

Manfred Stamer
Senior Economist for Middle East and Emerging Europe
manfred.stamer@allianz-trade.com

Corporate Research

Ano Kuhanathan
Head of Corporate Research
ano.kuhanathan@allianz-trade.com

Aurélien Duthoit
Senior Sector Advisor
aurelien.duthoit@allianz-trade.com

Maria Latorre
B2B Sector Advisor
maria.latorre@allianz-trade.com

Maxime Lemerle
Lead Analyst for Insolvency Research
maxime.lemerle@allianz-trade.com

Capital Markets Research

Jordi Basco-Carrera
Lead Investment Strategist
jordi.basco_carrera@allianz.com

Pablo Espinosa Uriel
Capital Market Research Analyst
pablo.espinosa-uriel@allianz.com

Insurance, Wealth and Trends Research

Michaela Grimm
Senior Expert demographics
michaela.grimm@allianz.com

Patricia Pelayo-Romero
Expert Insurance
patricia.pelayo-romero@allianz.com

Kathrin Stoffel
Expert Wealth
kathrin.stoffel@allianz.com

Markus Zimmer
Senior Expert ESG
markus.zimmer@allianz.com

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Director of Publications
Ludovic Subran, Chief Economist
Allianz Research
Phone +49 89 3800 7859

Allianz Group Economic Research
https://www.allianz.com/en/economic_research
http://www.allianz-trade.com/economic-research
Königinstraße 28 | 80802 Munich | Germany
allianz.research@allianz.com

@allianz
allianz

Allianz Trade Economic Research
http://www.allianz-trade.com/economic-research
1 Place des Saisons | 92048 Paris-La-Défense Cedex | France
research@allianz-trade.com

@allianz-trade
allianz-trade

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