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Allianz Research

Economic and Market Outlook
Running up the hill

Executive summary

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- **Global growth is entering a soft patch this year as uncertainty due to geopolitical risks remains high.** We expect global GDP growth at +2.9% this year and +2.5% in 2023, down by -0.4pp and -0.3pp compared to our last forecast in March. The revision is due to the larger direct and indirect impacts from the war in Ukraine and the longer-than-expected lockdowns in China, which will reduce output by -1.2pp and -0.6pp in 2022 and 2023, respectively. Global trade has most probably contracted in Q2 (-1.3% q/q). The Chinese reopening will support some catch-up effects for trade, and therefore global GDP growth, going into the summer, but we expect a rather timid recovery. We now forecast global trade to grow by +3.5% in 2022 and +3.6% in 2023 in volume terms, much below consensus. In value terms, the strength of the US dollar coupled with high inflation in 2022 will push nominal growth to +10.4% before it slows to +4.2% in 2023.

- **While a soft landing remains our baseline scenario for 2022, downside risks of a recession are building up fast. This time the concern is not only about the magnitude of the recession, but also the distribution effects.** As record-high inflation (8.1% in 2022 at the global level) degrades real disposable incomes, households and corporates are likely to scale back consumption and investments, respectively. While consumer sentiment is plunging, business confidence is still holding up. However, lower planned capex suggests that corporates are becoming more cautious. As inflation stays high for longer (4.7% in 2023 globally; above 3% in the US, Eurozone, UK), the risks of a wage-price loop are increasing. A complete and disorderly suspension of oil and gas imports from Russia to the EU by year-end could bring about our "adverse" scenario (40% probability), in which the major economies are pushed into a recession. In this scenario, policymakers would fail to save the day à la 2020 as central banks' initial fixation on fighting inflation constrains fiscal policy options. Meanwhile, the expected policy u-turn in H1 2023, including aggressive rate cuts, would come too late.

The suspension of oil and gas imports from Russia to the EU is expected to cost -1.6pp of EU GDP growth as we estimate the energy shortfall after substitution and self-rationing at about 4% of final energy consumption against 10% in March. Overall, taking into account the additional impact from tightening monetary and financial conditions, we expect global GDP growth would contract by -2.8pp in 2023 to -0.3% in the adverse scenario (after slowing by -0.3pp to +2.6% in 2022). This implies a recession of -1.4% in the US and -2.5% in the Eurozone and the UK – roughly 1.5-standard deviations from two-year trend growth in terms of output loss. China's growth would slow to +2.5% in 2023.

- **Policy space to contain downside risks is diminishing quickly.** Central banks in advanced economies have become more determined to aggressively tackle inflation as supply-side price pressures remain strong. We expect the Fed to increase interest rates to at least 3.5% by end-2022 and the ECB to 0.75%. However, tightening financing conditions to dampen aggregate demand can easily trigger a recession, especially in countries where the recovery from the Covid-19 crisis is still not complete. Fiscal policy can help to limit adverse distributional effects but will not be enough to stave off the growth slowdown and could perpetuate high inflation. In our adverse scenario, we expect inflation-focused monetary tightening to cause a sizable contraction of demand, resulting in a global recession in early 2023, amplified by depressed asset prices. In this situation, we expect global GDP growth to contract by -2.6pp in 2023 to -0.1% (after slowing by -0.3pp to +2.6% this year).

- **Capital markets are getting fickle.** The hawkish shift of major central banks (with the exception of China and Japan) has unsettled fixed income and equity markets alike. Rising rate expectations have led to a significant upward revision of long-term rates. We expect the 10Y benchmark Bund yield at 1.5% by end-2022 and the 10Y US Treasury yield at 3.2%. Equity markets have corrected by more than -20% already since the beginning of the year and still have room to drop further. Market movements have been extreme but volatility remains contained compared to past stress episodes. We expect equities to remain under pressure for the remainder of the year on the back of continued pressures on corporate margins. Credit spreads have exhibited a pattern similar to that of equities but have remained relatively resilient. For emerging markets, risks keep building up due to the double whammy of more aggressive Fed tightening and slowing external demand, which will continue to intensify net capital outflows. We see limited upside potential for commodity exporters in the short-term. In addition, geopolitical risks have raised concerns about investments in China.

- **What does this mean for corporates?** High cost pressures are dampening some investment prospects, but some catch-up effects might be likely in H2 as input shortages reduce significantly and supply normalizes while demand slows down further. However, structural headwinds such as higher energy prices (with oil averaging 105 USD/bbl in the remainder of 2022 and remaining over 90 USD/bbl well into next year) coupled with rising interest rates and wage acceleration would continue to put pressures on corporate margins going forward. Simulating the impact of an increase of 200bp in corporates' interest rates, we estimate that profitability is most at risk in construction, energy, transportation and computers & telecom, with the impact after one year ranging, depending on the sector, from -5.7pp to -2pp margin loss in the US and more than -7pp to -3pp in the Eurozone. After two years of declines, we expect global business insolvencies to rebound by +10% in 2022 and +14% in 2023, approaching their pre-pandemic level. One in three countries will return to pre-pandemic levels in 2022 and one in two countries in 2023.

+2.9%

Forecast for global GDP growth in 2022

A soft patch for global growth

We forecast global GDP growth at +2.9% in 2022 and +2.5% in 2023, down by -0.4pp and -0.3pp compared to mid-March[1], respectively, amid still-rising inflation. Adverse inflation dynamics persist due to continued supply-demand imbalances, tight labor markets and still strong goods demand as ruptures in energy markets and input shortages slow the recovery. In the US, consumer confidence is deteriorating fast while in Europe it has already reached the lows seen during the pandemic. In both the US and Europe, business confidence is still holding up but cautiousness is rising, with an increasing share of corporates revising down capex plans. High cost pressures are also dampening investment, but some catch-up effects are likely in H2 when supply normalizes and demand slows down further. However, structural headwinds such as higher energy prices (hovering around 100 USD/bbl as long as the war continues) coupled with rising interest rates and wage acceleration would continue to put pressures on corporate margins.

The total cost of the direct and indirect impact from the war in Ukraine, coupled with the longer-than-expected lockdowns in China, stands at -1.2pp and -0.6pp of GDP for 2022 and 2023. In quarterly terms, GDP growth is back to 2019 lows: +0.2% in the US and +0.3% q/q in the Eurozone. Overall, our forecasts stand below consensus, notably for 2023, at +1.0% in the US and +1.5% in the Eurozone. The Chinese reopening will support some catch-up effects for trade and therefore global GDP growth going into the summer, but we expect a rather timid recovery (+4.1% in H2 over H1 2022, compared with +10.8% in H2 2020 over H1 2020). In 2023, China's quarterly GDP growth will not average more than +1%. Risks to domestic demand are high as inflation continues to bite into real disposable incomes and corporates start to be increasingly cautious. However, warnings of an imminent recession are overblown (capital goods shipments are still solid, inventories are being replenished and labor markets remain tight).

[1] See our report Economic Outlook: Energy, trade and financial shockwaves.

We forecast global trade to grow by +3.5% in 2022 in volume terms, much below consensus. Global trade is expected to have contracted in Q2 (-1.3% q/q)[2], mainly due to supply constraints linked to the lockdowns in China. Looking ahead, China's mild reopening will help the trade recovery. Global trade should grow by +1.1 q/q in Q3 and +0.8% in Q4 2022. Barring further waves of Covid-19 infections, we expect stringency at the national level in China to normalize in July – even if the zero-Covid policy remains a risk. This means that industrial activity should recover mildly, and manufacturers dependent on Chinese goods could experience some relief in the fall as it will take two to three months for port congestion to normalize. We expect the largest production boost to the agrifood, pharma and software & IT services sectors in Europe and the US. Overall, we now forecast global trade to grow by +3.5% in 2022 in volume terms, down from our previous forecast of +4.0% (and much below consensus ranging between +4.5% and +5.0%). In value terms, global trade is now set to grow by +10.4% in 2022, with the trade price component more than three times higher than what we expected before the war in Ukraine and the lockdowns in China.

Figure 1: Global GDP growth forecasts

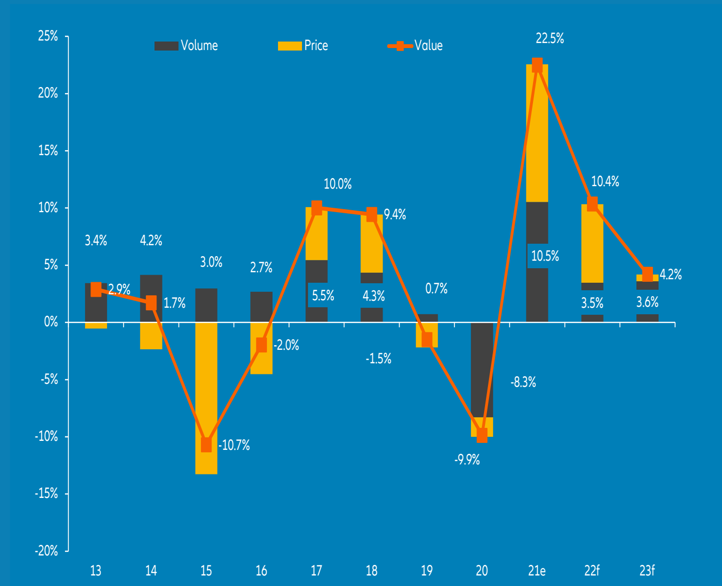
	Baseline scenario				Adverse scenario	
	2020	2021	2022f	2023f	2022f	2023f
Global	**-3.4**	**5.7**	**2.9**	**2.5**	**2.6**	**-0.3**
USA	**-3.5**	**5.7**	**2.0**	**1.0**	**1.7**	**-1.4**
Latin America	**-6.9**	**6.5**	**2.1**	**1.4**	**1.6**	**1.1**
Brazil	-4.1	5.0	0.9	0.6	0.3	0.3
UK	**-9.9**	**7.1**	**3.2**	**1.0**	**3.0**	**-2.5**
Eurozone	**-6.5**	**5.2**	**2.8**	**1.5**	**2.4**	**-2.5**
Germany	-4.9	2.9	1.7	1.4	1.5	-2.3
France	-8.0	6.8	2.5	1.5	2.3	-2.5
Italy	-8.9	6.5	2.6	1.5	2.2	-3.5
Spain	-10.8	5.0	3.9	1.9	3.4	-3.0
Russia	-2.7	4.7	-8.0	-3.0	-13.5	-6.0
Turkey	1.8	11.0	2.8	3.0	1.0	1.4
Asia-Pacific	**-0.9**	**6.1**	**4.0**	**4.5**	**3.5**	**1.1**
China	2.3	8.1	4.1	5.2	3.8	2.5
Japan	-4.7	1.7	1.6	1.8	1.4	-1.5
India	-7.3	8.7	7.2	6.6	6.8	1.8
Middle East	**-4.7**	**3.5**	**5.1**	**3.1**	**5.5**	**2.7**
Saudi Arabia	-4.1	3.2	7.6	3.3	8.0	2.8
Africa	**-2.6**	**3.1**	**3.1**	**3.6**	**2.5**	**2.3**
South Africa	-6.4	5.0	1.9	1.8	2.0	1.5

Source: Allianz Research

Inflation will only peak in late summer, driven by higher energy and food prices. Global inflation should average 8.1% in 2022 and 4.7% in 2023. Risks of a wage-price loop are increasing. After a short-lived pause in April, inflation dynamics picked up again notably in May. Eurozone headline inflation jumped by +0.7pp to a new all-time high of 8.1% (consensus: 7.8%), mostly due to re-accelerating energy inflation (up +1.7pp to 39.2%) and surging food prices (7.5% after 6.3% in April). Similarly, in the US, headline inflation accelerated again to a new 40-year record of 8.6% (consensus: 8.3%) due to soaring gasoline prices and costs for shelter. On both sides of the Atlantic, increasing core inflation points to price pressures broadening to goods and services. The inflation outlook remains highly uncertain and a further increase cannot be ruled out. The post-Covid rotation back to services and increasing commodity prices (with Brent oil soaring following the announcement of an EU embargo on Russian oil) will keep inflation elevated going into the summer. The upcoming de facto energy embargo has already pushed oil prices to a peak above 120 USD/bbl in June. Prices should consolidate in the coming months but they are likely to remain above the 100 USD/bbl threshold, assuming a rotation in the demand for Russian oil continues (i.e. nations such as India and China continue to buy Ural oil). In a full black-out scenario, the supply constraint will push oil prices up to 150 USD/bbl. In terms of a gas embargo, as EU nations have the possibility to restock, we do not expect a price peak before next winter, most likely in December or January. However, prices should remain 'capped' (close to 200 EUR/MWh) as the market will at some point run into a pure supply issue, regardless of price levels. The longer it takes to reach the peak in inflation (not before late summer), the upside pressures on wages will continue. We expect wage growth at +4.1% in the Eurozone in 2022 and +4.2% in 2023. In the US, we expect wage growth to remain at +4.1% in 2023 after +5.2% in 2022, against +4.9% and +3.5% in the UK, respectively.

[2] See our report A trade recession before a mild Chinese reopening?

Figure 2: Total trade of goods and services, y/y



Source: Allianz Research

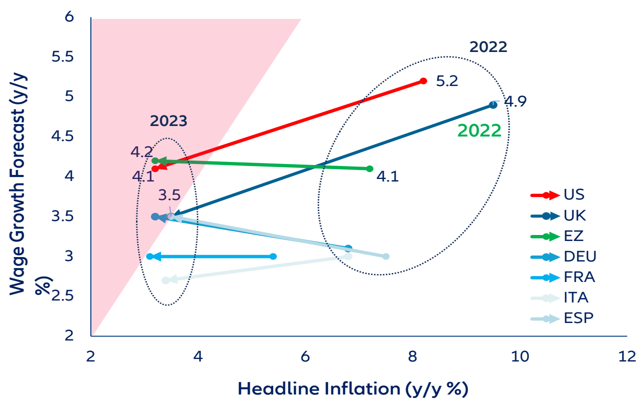
Figure 3: Inflation rates, %

	2021	2022f	2023f
Global	**4.9**	**8.1**	**4.7**
USA	**4.7**	**8.2**	**3.2**
Latin America	**12.8**	**12.8**	**8.3**
Brazil	8.3	9.1	4.5
UK	**2.6**	**9.5**	**3.5**
Eurozone	**2.6**	**7.2**	**3.2**
Germany	3.2	6.8	3.2
France	2.0	5.4	3.1
Italy	2.0	6.8	3.4
Spain	3.1	7.5	3.5
Russia	6.7	15.1	12.0
Turkey	19.4	67.1	19.0
Asia-Pacific	**1.6**	**3.4**	**2.8**
China	0.9	2.6	2.2
Japan	-0.2	1.9	1.5
India	5.5	6.6	5.2
Middle East	**11.8**	**13.1**	**9.6**
Saudi Arabia	3.1	2.4	2.4
Africa	**12.7**	**13.9**	**9.2**
South Africa	4.6	6.5	4.6

Source: Allianz Research

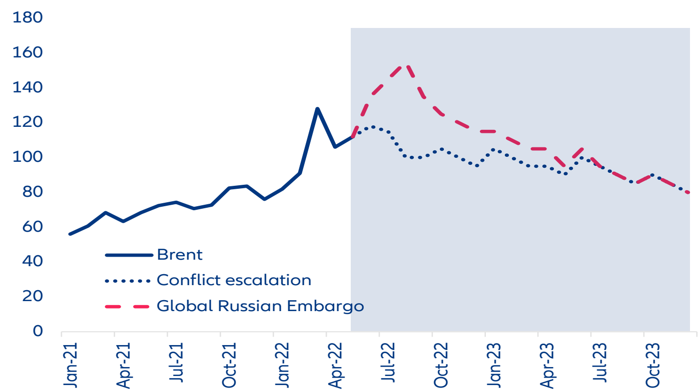
In China, consumer inflation is likely to peak only in early 2023 for both headline and core rates. Supply-chain tensions are easing but will remain elevated in 2022. The post-omicron reopening of China should help improve access to goods and inputs, especially from autumn, and cooling demand thereafter could help unwind supply-demand balances. Rises in the coming months will be supported by improving demand from the economic recovery (easing of sanitary restrictions) and the low base effects on food prices. We expect a gradual normalization of inflationary pressures in both Europe and the US during H2 2022 due to base effects, but inflation will remain above 2% until 2024. In Europe, fiscal support measures will help contain inflation by about -0.5pp through the year (e.g. fuel rebate in Germany and electricity price caps in France, Spain and Portugal). However, core inflation will remain high throughout the forecast horizon in the Eurozone: 3.5% and 2.5% in 2022-23. In China, inflation should slow to 2.2% in 2023 after 2.6% in 2022.

Figure 4: Wage growth forecast



Sources: Refinitiv, Allianz Research

Figure 5: Oil price forecast

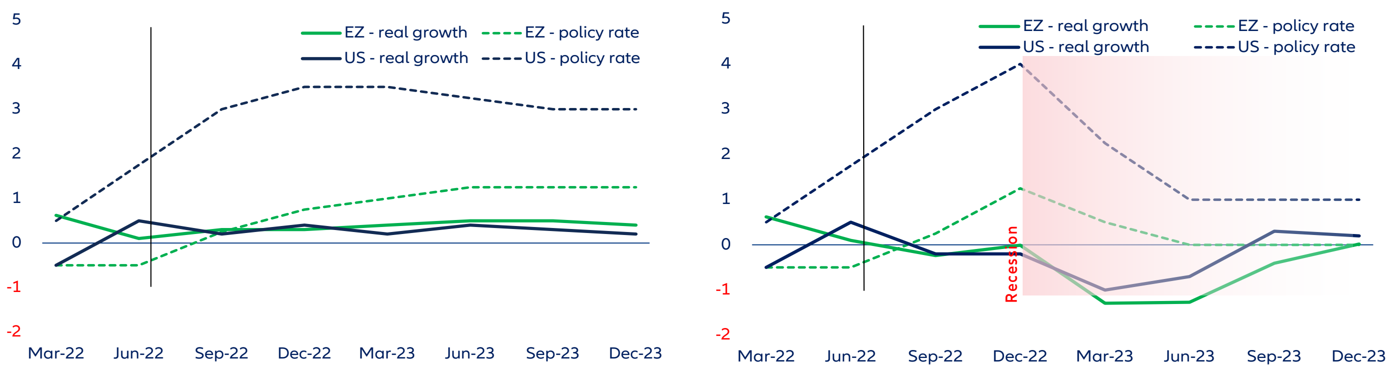


Sources: Refinitiv, Allianz Research

We are entering into a global monetary tightening cycle, with global rates above their 2018 peaks: The US Fed fund rates is expected at 3.5% by end 2022, the BoE at 2% and the ECB deposit rate at 0.75%. Central banks in advanced economies have become more determined to aggressively tackle inflation as supply-side price pressures remain strong and have lasted long enough to increase price expectations for corporates and households. In a world of negative supply-side shocks from product and labor markets, higher inflation coincides with economic slack, which makes it challenging for central banks to raise rates without significantly dampening aggregate demand. The traditional paradigm of central banks achieving their price stability target whenever the economy reaches potential output ("divine coincidence") no longer holds. Markets expect that policy rates will reach (or even exceed) the neutral rate by the end of the year. Greater economic slack in the Eurozone is likely to restrain a steeper hiking cycle, which carries an increasing risk of inflation broadening despite lower potential growth. Central banks in emerging market countries that started their tightening cycles much earlier than their peers in advanced economies might now come under increasing pressure, especially those that have little room to tighten further. China remains the exception, where further easing through liquidity tools will help keep interbank rates low without further high-profile policy rate cuts.

Since most central banks strive to avoid depreciating currencies as upside inflation risks remain high, there is also a risk of reverse currency wars. The Fed and the ECB are also opening up to larger rate hikes in the future if price pressures do not abate, which reinforces the tightening cycle and makes the flattening of yield curves more enduring. In addition, the SNB's surprise 50bps hike and change in FX reference as well as the Bank of Japan's changes in rhetoric suggest that FX considerations have prominently factored into recent central bank decisions. The above -7% depreciation of the EUR since the start of the year is likely to push inflation up by +0.8pp after one year. Several research papers show that in light of their trade structures, countries such as the UK, US, Canada and the Nordics benefit more from a strong currency (e.g. in terms of inflation, export performance) as the J-curve is not actioned by a depreciation. We expect the EUR/USD to reach 1.08 by end-2022 and 1.13 on average in 2023.

Figure 6: Eurozone and US: quarterly profile of real growth rate and policy rates

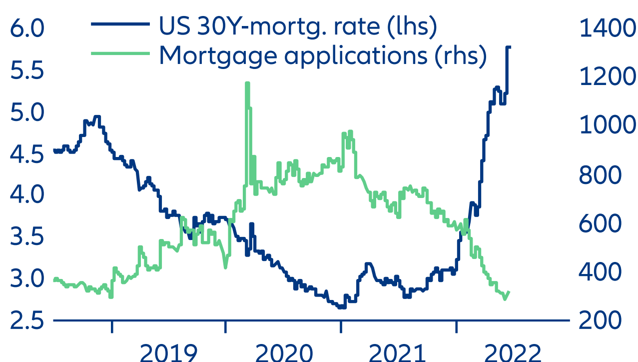


Sources: Refinitiv Datastream, Allianz Research

How much monetary policy normalization can we afford? Tighter financing conditions have already caused a significant correction of asset prices across the board at a time when high inflation gives little hope that central banks would support markets, and when rising rates remove bonds as a hedge for risky assets. Tighter financing conditions also exacerbate the impact of diminishing real purchasing power on consumption and investment by households and corporates. US mortgage rates have already doubled, which has resulted in a decline of mortgage applications and home sales. While a cooling housing market could help limit the broadening of inflationary pressures, it also impairs the resilience of US households' balance sheets; adverse knock-on effects on consumer spending could make it more difficult for the Fed to engineer a soft landing during the current hiking cycle. Despite a majority of corporates stating that they want to further increase selling-price expectations, after unexpectedly high pricing power in Q1, we estimate that half of corporates will struggle to pass on higher financing and producer prices to consumers, which will further erode corporate margins and raise bankruptcy rates. Simulating the impact of an increase of 200bp in corporates' interest rates, we estimate that profitability is most at risk in construction, energy, transportation and computers & telecom, with the impact after one year ranging, depending on the sector, from -5.7pp to -2pp margin loss in the US and more than -7pp to -3pp in the Eurozone.

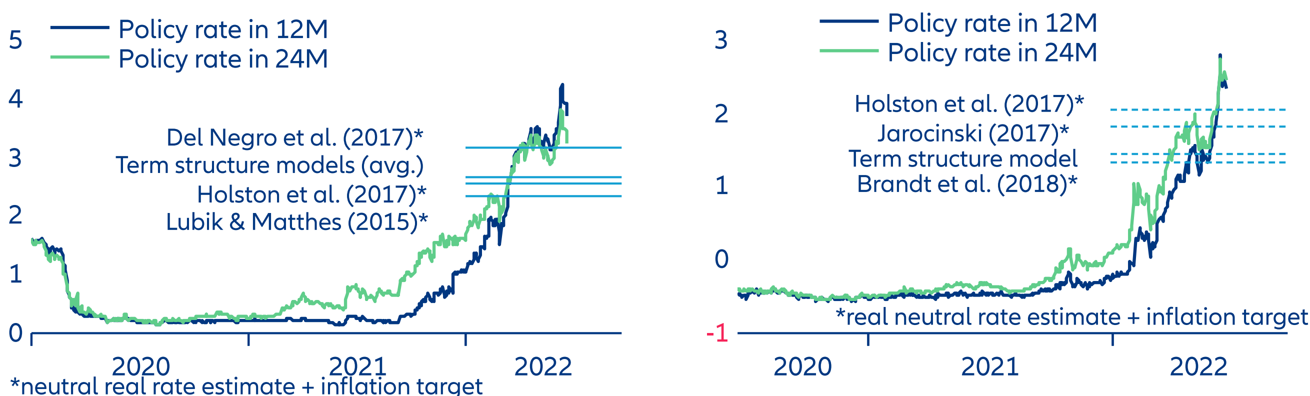
After two years of declines, we expect global business insolvencies to rebound by +10% in 2022 and +14% in 2023, approaching their pre-pandemic level. One in three countries will return to pre-pandemic levels in 2022 and one in two countries in 2023

Figure 7: US: housing market



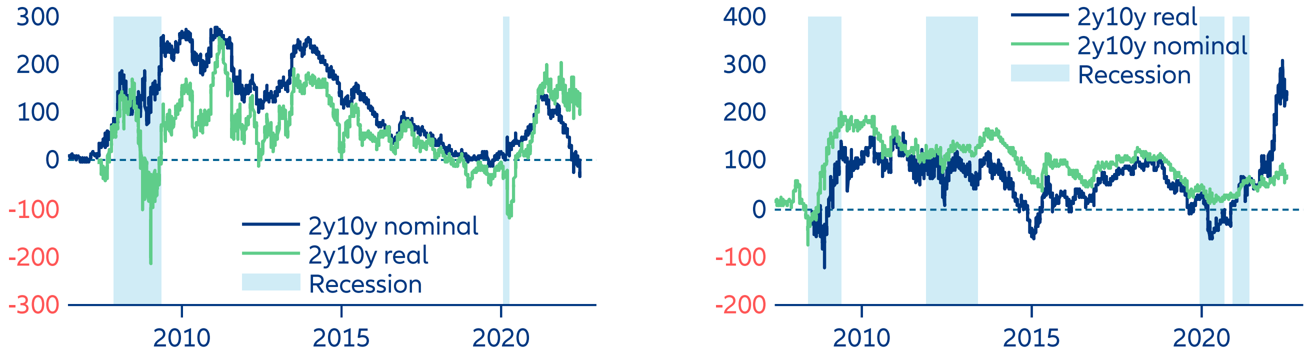
Sources: Refinitiv, Allianz Research

Figure 8: Eurozone and US: policy rate expectations and neutral rate estimates



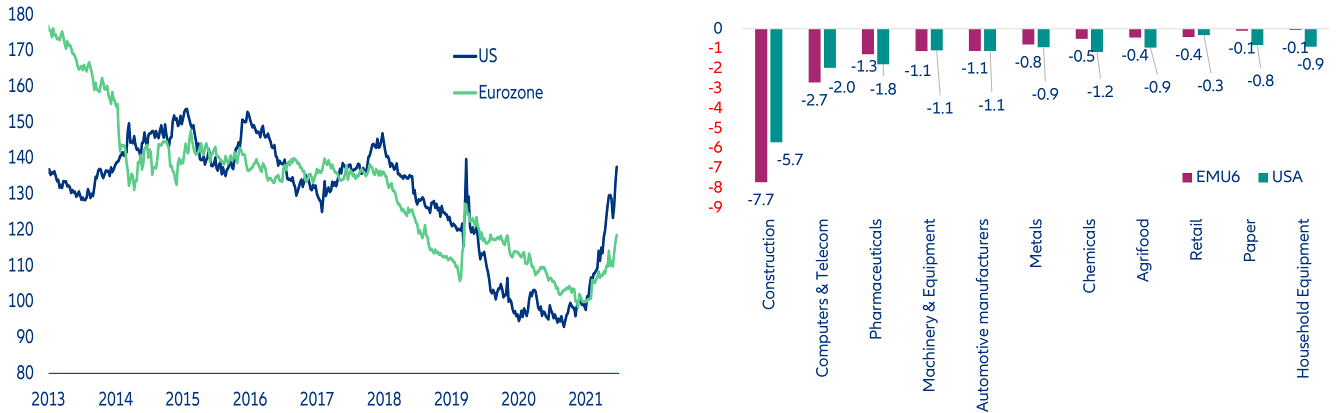
Sources: Refinitiv Datastream, Allianz Research

Figure 9: US and Eurozone government yield curves



Sources: Refinitiv Datastream, Allianz Research

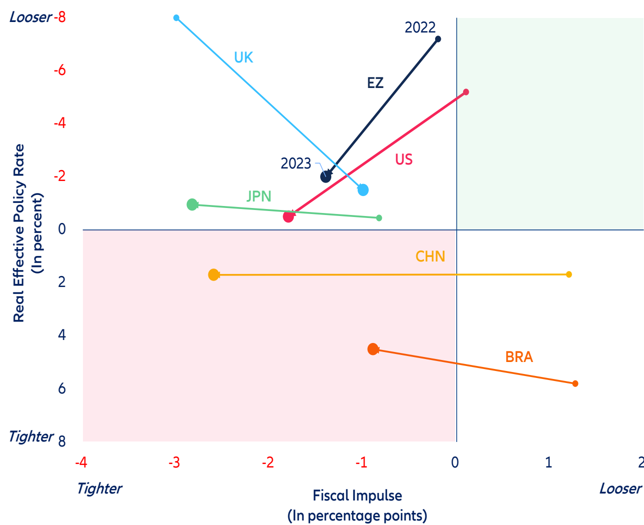
Figure 10: Monetary and financial conditions index and impact on corporate margings (pp changes vs 2021 for a 200bps-increase in interest rates)

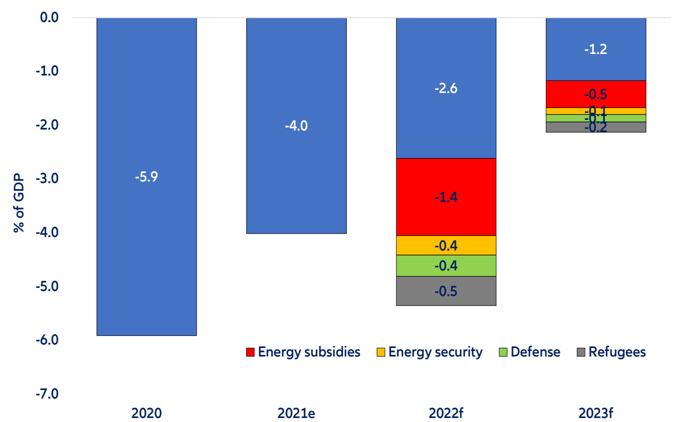


Sources: Goldman Sachs FCIs, Allianz Research

Fiscal policy can help but support will fall short of staving off the growth slowdown. The war in Ukraine has resulted in additional discretionary spending to cushion the blow from higher energy prices and support collective safety and defense, including support for refugees from Ukraine. This has slowed the pace of fiscal adjustment, especially in Europe, where we estimate that the primary balance could easily exceed 5% of GDP this year due to significant energy support to the tune of 1.5% of GDP on average (Figure 11). However, over the near term, we see a general withdrawal of fiscal support, with a strong fiscal consolidation in the US when the economy is at risk of slipping into a recession. After unwinding pandemic-related measures this year, a likely Republican-dominated Congress will push for spending cuts next year.

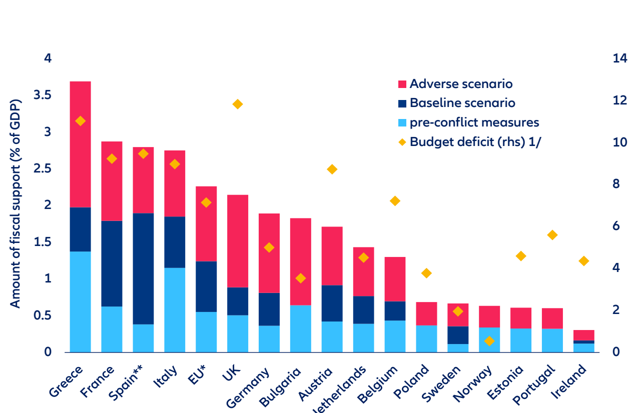
Figure 11: Fiscal Impulse (2022-2023) in large economies cyclically-adjusted primary balance in the Eurozone





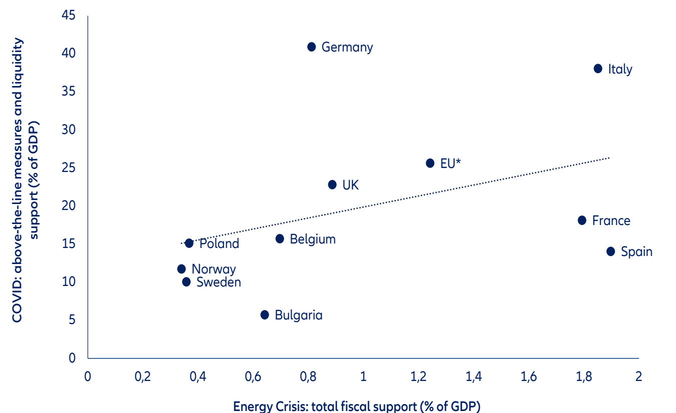
Source: Allianz Research

Figure 12: Eurozone: Estimated fiscal support and comparison with Covid-19 crisis measures



Sources: National authorities, Allianz Research.

Note: The fiscal measures for countries with price caps and reductions of energy surcharges include the estimated additional fiscal cost for a 50-percent energy price increase. 1/ Budget deficit as quaterly average between Q1 and Q3 2021; */ EU is approximated as the GDP-weighted average of the sample countries; /** Spain's fiscal expenditures is based on the assumption of a energy subsidy of €150 for 11.5mn (lower-income) households.



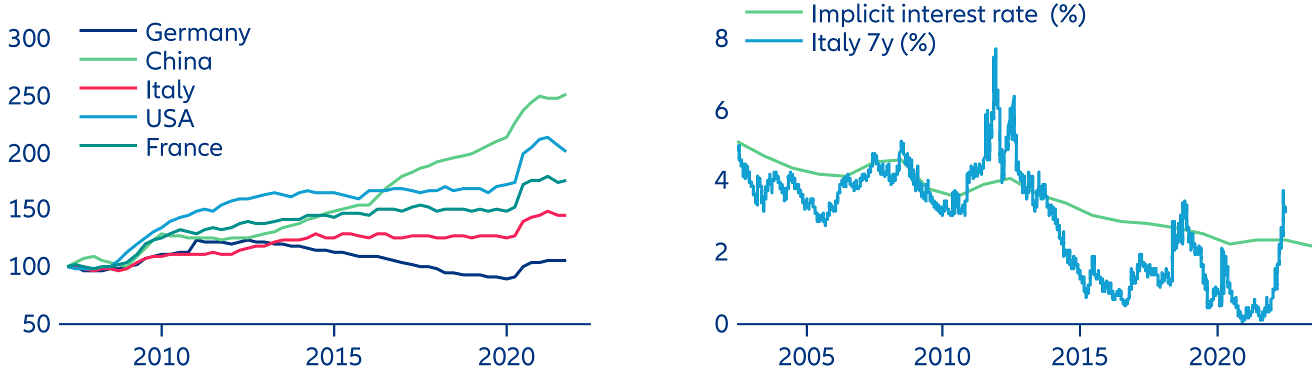
Sources: IMF, Allianz Research.

Note: */ EU is approximated as the GDP-weighted average of the sample countries.

The specter of sovereign debt distress is emerging in Europe. A widening of sovereign spreads due to rising rates raises the refinancing cost of vulnerable Eurozone countries, such as Italy, that are struggling with widening deficits and low potential growth. So far, high inflation and NGEU funds from the EU have helped stabilize the debt level. However, as real rates increase and growth keeps slowing, fiscal space will diminish rapidly. With a general election scheduled in Italy for H1 2023, we see an elevated risk for a period of political instability ahead. While a sensible national reform program, including a responsible fiscal consolidation plan, remains key to instill confidence in Italian debt, mitigating EU reform steps will likely be necessary, too. More demands on fiscal policy amid rising social discontent might call for an extension of national budget firepower via a centralized EU fiscal capacity to fund essential spending (e.g. climate transition and defense).

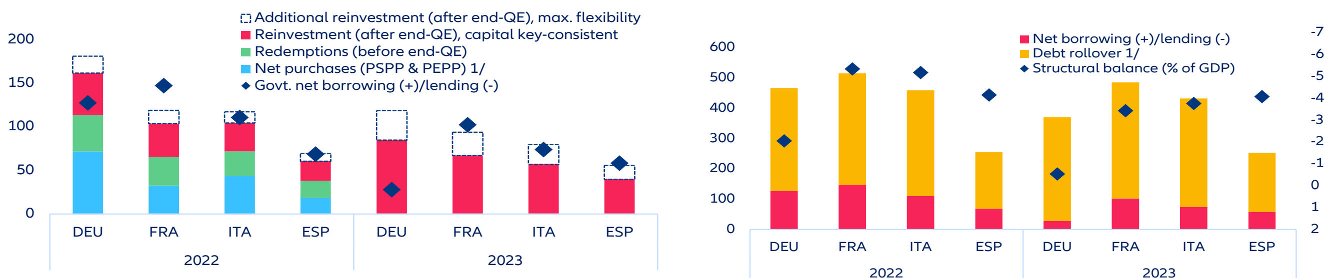
Fragmentation risk weighs on the ECB's rate-hiking ambitions. Flexibility in managing the reinvestment of the ECB's maturing sovereign debt holdings would be required for a transitional period to reduce fragmentation risk. But this will at best buy time while the ECB is working on a spread-control program to ensure that bond market stress is no obstacle to policy normalization. Key challenges remain, including if and how the liquidity injection from bond purchases would be sterilized. Unlike the ECB's asset purchases under PEPP, which aimed at cushioning the common shock from Covid-19, any anti-fragmentation measure would redress market distress from poor fiscal governance and, thus, would likely come with some strings attached, according to the ECB's doctrine. Such conditionality might be hard for Italy to accept if a new government formed by a conservative alliance wins the upcoming elections. Also, no matter its design, such an instrument is unlikely to be effective in addressing redenomination risk. Our calculations suggest that even if reinvestments are done flexibly (including front-loading by up to one year), the ECB will struggle to absorb the net financing needs of the vulnerable large economies. And this does not consider the additional interest burden from higher debt-rollover costs (see Figure 13).

Figue 13: Sovereign debt levels (% over GDP, rebased to 100 = 01/01/2007) and Italian government refinancing cost



Sources: Refinitiv Datastream, Allianz Research

Figure 14: Eurozone: Estimated Eurosystem purchases of government debt and estimated refinancing needs



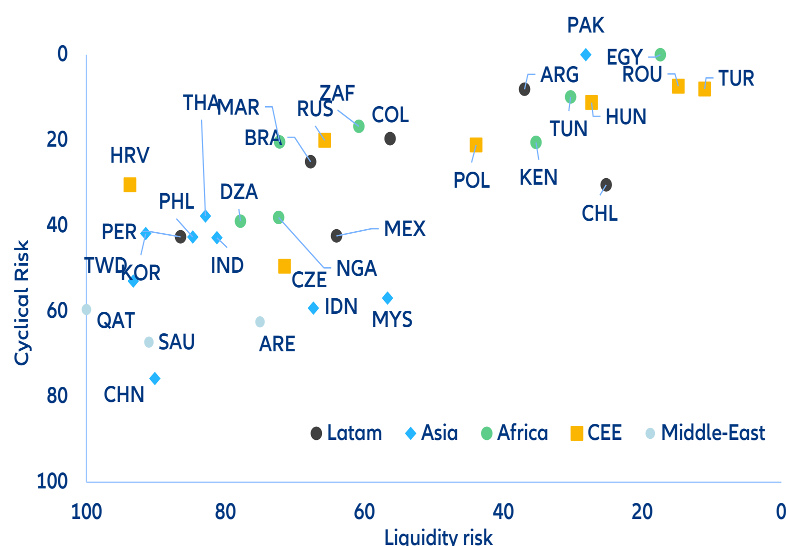
Sources: ECB, IMF, Refinitiv, Allianz Research.

Note: 1/ PSPP=public sector asset purchase program; PEPP=pandemic emergency purchase program.

Risks are on the rise for emerging markets on the back of faster monetary policy tightening and worsening geopolitics. EmergingMarkets (EMs) have been hit by the double whammy of rising inflation due to surging global energy and food prices and capital withdrawal in the wake of monetary tightening in advanced economies (AEs), especially the aggressive interest rate hiking by the US Fed. Both developments have forced EMs into implementing substantial interest rate hikes as well in order to contain inflationary pressures and to remain attractive for foreign investors. In this context, weaker EMs will be more exposed to the liquidity squeeze and some countries may find it harder to refinance debt commitments in the face of higher borrowing costs and pressures on their currencies. Sri Lanka has been the first victim of the deteriorated global environment for EMs as the sharp rise in food prices contributed to diminishing foreign exchange reserves, which ultimately led to the country's first sovereign debt default in history in May 2022.

Could other EMs be next? We have updated our analysis of EM vulnerabilities to sharp monetary tightening in AEs with regard to liquidity risk (current account balance, short-term external debt due, import cover, private sector credit growth) and cyclical risk (currency risk, inflation, commodity dependence, equities, bonds). We find a group of 10 major EMs that are particularly susceptible (see Figure 15). Apart from Argentina and Turkey – which have idiosyncratic risks due to repeated policy mistakes since 2018 – the group includes Pakistan, Chile, three African countries (Egypt, Kenya, Tunisia) and three CEE markets (Hungary, Poland, Romania). Six out of these 10 countries (Egypt, Tunisia, Pakistan, Argentina, Turkey, Kenya) are also among the top 25 most vulnerable EMs with regard to public debt sustainability (out of 101 markets monitored in our recent analysis)[3]. Hence, these markets could face a sovereign debt crisis in the next two years or so. The other four susceptible EMs (Chile, Hungary, Poland, Romania) are less likely to face public debt problems in the near future but rather liquidity risks in the private sector, owing to the global liquidity squeeze and currency pressures. Indeed, Hungary's forint has already lost -8% vs. the euro year-to-date as the country is experiencing a rising current account deficit while its FX reserves are low (2.2 months import cover). And Hungary's ongoing disputes with the EU are not helpful to restore investor confidence.

Figure 15: Vulnerabilities to sharp monetary tightening in AEs



Sources: Refinitiv, Allianz Research

[3] See our report Economic Outlook: Energy, trade and financial shockwaves, p. 23.

Weakening global demand will not help vulnerable EMs to export themselves out of the crisis this time, especially if the hazards to global growth: continued bottlenecks in supply chains, disrupted commodity markets or stringent anti-Covid policies, some of which have been aggravated by the war in Ukraine.

EMs began to embark on monetary tightening about a year ago in order to tackle the impacts of rising inflation and the global liquidity squeeze and they will need to continue with it. Inflation is expected to peak in Q3 2022 in most markets but interest rate hikes are likely to continue at least until the end of the year, because AEs will also tighten and many EMs still have substantial negative real policy rates, especially in Emerging Europe. The latter as well as Latin America, Africa and the non-oil exporting Middle East will experience regional double-digit inflation on average in 2022 and, consequently, more pronounced rate hikes. In contrast, Emerging Asia and the GCC will see much lower inflation in the range of 3-4% in 2022.

Meanwhile, commodity exporters have benefited from the price spillovers due to the war in Ukraine. And our analysis shows that these markets are currently less vulnerable to monetary tightening in AEs. This should continue until the end of 2022 at least. However, weaker global demand and recession risks at the beginning of 2023, potentially aggravated by the effects of China's zero-Covid policy, could eventually result in easing non-oil commodity prices and weaken the current position of countries that are net exporters of these goods. Oil and gas prices, however, are expected to remain elevated until the end of 2023.

Capital markets are getting nervous. The hawkish shift of major central banks (with the exception of China and Japan) has unsettled fixed income and equity markets alike. Rising rate expectations have led to a significant upward revision of long-term rates. We expect the 10Y benchmark Bund yield at 1.5% by end-2022 and the 10Y US Treasury yield at 3.2%. Equity markets have corrected by more than -20% already since the beginning of the year and still have room to drop further. Market movements have been extreme but volatility remains contained compared to past stress episodes. We expect equities to remain under pressure for the remainder of the year as recession concerns and elevated inflation weigh on corporate margins. Credit spreads have exhibited a pattern similar to that of equity markets but have remained relatively resilient. For emerging markets, rising risks will continue to intensify net capital outflows. We see limited upside potential for commodity exporters in the short-term. In addition, geopolitical risks have raised concerns about investments in China.

Political risk is back. Important elections taking place over the coming 18 months will likely see key economies increasingly prioritize domestic issues, at least temporarily. In H2 2022, all eyes will be on leadership contests in the world's two largest economies. Hence, expect the US and China to turn their focus above all to domestic affairs, away from Taiwan and Ukraine. In the US, midterm elections will reach their climax on 08 November, when the first nationwide vote since the 2020 presidential election is scheduled. As President Biden's approval ratings have been falling from one record low to another, Democrats are unlikely to retain their (slim) majority in Congress. Last minute attempts to pull back on less popular goals and to extend more support to a slowing economy should not be ruled out. Meanwhile, in China, the coming months will be punctuated by crucial political events: the CCP's 20th National Congress (likely around November) and a plenum in March 2023 that will officialize the party and state leaders for the coming five years. Policymakers will likely aim for stable and managed economic and sanitary situations in the run-up to these events, meaning further policy support to short-term growth amidst the zero-Covid policy. Judging from the pace of vaccination in the past months and taking a modest assumption (i.e. 0.2% of the population aged 60 years old or more receiving a booster shot every week, vs. c.1.5% on average in April), a sufficient level of immunity (75% vaccination rate among this population) could be reached in April 2023. It is thus possible that China only starts significantly easing its zero-Covid policy and potentially reopening borders in Q2 2023. In Europe, this year's 'make or break election' is behind us, with France's President Macron falling short of securing an absolute majority and looking to create a wider coalition, most probably with center-right Republican Party with "In Europe, this year's 'make or break election' is behind us, with France's President Macron falling short of securing an absolute majority. In this context, parliamentary agreement to key reforms has become very uncertain and will likely depend on whether the right-wing party 'Les Republicains' brings its backing (on an ad hoc basis). We expect that if Macron strives to rely on 'Les Republicains' to push through some of his agenda, and, thus, more fiscal consolidation could follow. However, with 2023 being an important election year in Southern European countries – with voters heading to the polls in Greece, Italy and Spain – fiscal consolidation efforts even in the most indebted countries will likely prove moderate at best next year, which in turn could further weigh on the ECB's policy normalization plans.

The "adverse" scenario (40% probability) builds on a complete and disorderly suspension of oil and gas from Russia to the EU by year-end, which would push major economies into recession. Policymakers fail to save the day à la 2020 as central banks' initial fixation on fighting inflation constrains fiscal policy options. Meanwhile, the expected policy u-turn in H1 2023, including aggressive rate cuts, comes too late. Looking at a full embargo on energy imports from Russia specifically, we estimate the energy shortfall after substitution and self-rationing at about 4% of final energy consumption against 10% in March. In a typical year, the EU-27 imports about 170,000 mcm of natural gas from Russia. The US exports about 100,000 mcm of LNG each year. Traditionally, the EU receives about 30% of these volumes but since January, it has received almost 75% of US volumes. We should expect this European preference to continue as long as the war lasts - meaning an extra 45,000 mcm/year for the EU. Although Qatar could also reorient its exports, it is tied with long-term contracts to Asian buyers thus unlikely to provide large extra volumes. However, we can expect an extra 15,000 mcm/year. Hence, this leaves us with 110,000 mcm to source, which is about 1,050,000 GWh/year. If the EU manages to reopen some coal-fireds plant (70% of which have not been operational since 2018), it could generate an extra 100,000 GWh/year. Germany, for instance, has 4.3 GW of coal plants on "reserve". Consequently, the EU would only be "missing" 950,000 GWh/year, which is about 8% of final energy consumption (down from the 10% we estimated in February).

Self-rationing will also be at play. According to recent research, the price elasticity of energy demand is close to 0.5 in Europe, which means we can expect a 20% decrease in consumption since energy/gas inflation is close to 40%. Thus, the region would lack about 500,000 GWh/year, which is about 30% of Russian imports or close to 4% of total final energy consumption. To deal with this mismatch of supply and demand, enforcing rationing will be needed in non-essential sectors. We could envisage further cuts in the following sectors: (i) an extra -30pp for households, taking household gas consumption to -40% from 2019 levels (this means an about 13% reduction in household energy consumption); (ii) an extra -20pp for all other non-essential industries and -10pp in service sectors and public administrations. Existing research highlights that in OECD countries, the energy elasticity of GDP is close to 0.6-0.7. However, these computations also include oil products for which the elasticity is higher than for electricity. We would rather use an elasticity close to 0.4 for electricity and gas. Consequently, we can expect a contraction of GDP of around -1.6% over four quarters in case of an enforced rationing, starting in Q4 2022. Overall in our adverse scenario, taking into account the additional impact from tightening monetary and financial conditions, we expect global GDP growth to contract by -2.8pp in 2023 to -0.3% (after slowing by -0.3pp to +2.6% in 2022). This implies a recession of -1.4% in the US and -2.5% in the Eurozone and the UK – roughly 1.5-standard deviations from two-year trend growth in terms of output loss. China's growth would slow to +2.5% in 2023.

Regional outlook

US: We have revised our US GDP growth forecasts downward on the back of a more aggressive Fed, persistently high inflation and a less supportive fiscal stance.

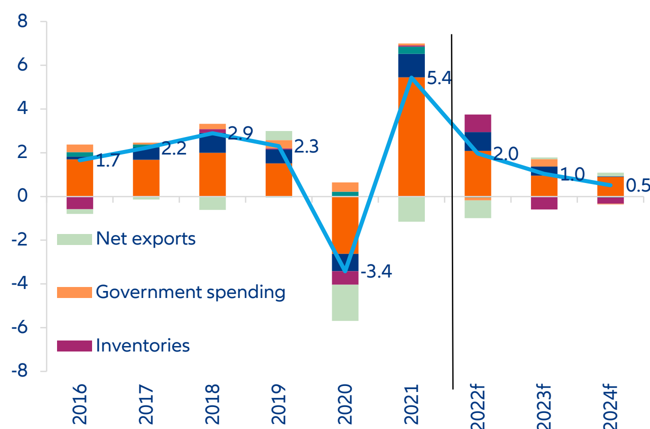
Forward-looking indicators and tighter financial conditions suggest that the US economy momentum during the second half of the year. On the housing market, higher mortgage rates are starting to weigh on new mortgage applications, though house-prices growth remains buoyant, owing to the limited supply of new homes. Steadily rising borrowing costs will nevertheless eventually dampen new construction activity. We expect residential investment to start weakening from the middle of 2023. Non-residential investment should prove resilient to higher funding costs, owing to generally heathy balance sheets amongst US corporates. However, despite elevated capacity-utilisation rates businesses are starting to cut back on their capital expenditure intentions, according to the Philly Fed survey. Persistently elevated inflation is also starting to weigh on consumer spending. US consumers accumulated large savings buffers during the pandemic, but these are being gradually eroded by higher prices. Meanwhile, we now expect fiscal policy

to turn less supportive. The Republicans will likely control Congress after the mid-term elections in November. In such a scenario, President Biden's Build Back Better bill – which has been stuck in Senate since last winter – will likely be watered down. More generally, there is less appetite in Washington DC for loose fiscal policy amid growing unease about high inflation. President Biden has called for a reduction of the federal deficit to help the Fed in taming inflation. In all, we now forecast US GDP to grow by +2% this year, before slowing down to a meagre +1% in 2023.

We have revised upward our inflation forecasts on the back of soaring energy prices: We now expect headline CPI inflation to rise by +8.2% on annual average in 2022, before easing off to +3.2% in 2023. There iis increasing evidence that high inflation is becoming more embedded into companies' price-setting behaviour and households' wage demands. For instance, the Atlanta Fed's wage-growth tracker and consumers' 12m-ahead inflation expectations are increasingly moving in tandem – signaling a more embedded wage-price feedback loop. Inflation is expected to ease from the second half of 2022, owing to powerful base effects and an easing of core goods price pressures. However, buoyant home-price inflation hints at a further pick-up in shelter inflation (one third of the CPI basket) in coming months, which will limit the easing of price pressures.

Tackling inflation has become the top priority at the Fed and we think that the slowdown of the economy will keep the FOMC undeterred. We now expect the Fed to hike interest rates to 3.5% by the end of the year. The Fed delivered an usually large 75bps-hike in the Fed Funds rate (FFR) during its June meeting – the largest increase since 1994. We expect the FOMC to carry on with an aggressive tightening throughout the rest of 2022, and we now foresee the FFR at 3.5% by December 2022. We think the Fed will keep rates at 3.5% through the end of Q2 2023, before slightly reversing its tightening cycle as the economy starts cooling and inflationary pressures abate. However, with inflation expected to remain stubbornly above target, the FOMC will retain a hawkish bias. We expect the FFR to decline to only 3% by end-2023 despite GDP growing well below trend. The reduction of the Fed's balance sheet started in June. The Fed plans to run down its securities holdings by USD47.5bn per month through September, before increasing this amount to USD97bn from September. This is a much faster pace of balance sheet run-off than during the previous episode in 2017-2018. We expect the Fed to stick to its USD97bn monthly run-off throughout the end of 2023. This will allow reserves balances to be maintained at a level of around 8.5% of GDP (from around 17% in 1Q22), consistent with an ample reserves regime.

Figuree 16: US GDP growth and components (%)



Sources: Refinitiv, Allianz Research

Eurozone

No notable growth rebound in 2023, with lingering recession risk. Eurozone GDP growth held up remarkably well during first half of 2022 in a context of a sharp energy price shock, prolonged supply-chain bottlenecks and elevated geopolitical uncertainty. Following an expansion of +0.6% q/q in the first quarter, the strong post-lockdown rebound in the sectors most impacted by the pandemic – notably travel and hospitality – will likely support a moderate growth momentum over the summer months. We expect prospects for Eurozone industry to brighten gradually during H2 2022 as supply-chain bottlenecks – triggered by China's zero Covid policy – start to ease. This will also allow a pick-up in over the course of 2023. However, unlike following the Covid-19 crisis, we do not expect growth momentum to pick up markedly in 2023 as key headwinds – including higher energy costs, elevated uncertainty and tightening financing conditions – are of a structural nature. And even though unemployment is likely to decline to new record lows (2023 forecasts: 6.8%), private consumption will expand at only a very moderate pace as wage growth (+4% on average in 2022-23) will fail to make up for the prolonged inflation overshoot, and the fiscal impulse will fade. Our view is supported by the rather gloomy forward-looking sentiment survey. For instance, in contrast to the resilient PMI headline, the forward-looking components, such as those for new manufacturing orders, fell below the neutral 50 mark, joining export orders, which turned negative in March. We expect the Eurozone economy to expand by +2.8% in 2022 – largely thanks to a solid growth carry-over of 1.9pp from 2021 – before GDP growth slows to only +1.5% in 2023 (0.5pp below the June consensus estimate). Meanwhile, risks remain clearly tilted to the downside, with a significant probability of a sharp recession.

ECB starting to gradually normalize its monetary stance. Despite high inflation pressures – 7.2% in 2022 and 3.2% in 2023 – the ECB is likely to pursue a gradual but resolute normalization of its monetary stance in H2 2022. The ECB has already pre-committed to kicking-off the rate hiking cycle in July and is expected to raise policy rates by 25bps at every policy meeting until year-end– with the exception of a likely 50bps hike in September, which will bringing the deposit rate to 0.75% (and the main refinancing rate to 1%). Given the still sizeable output gap in the Eurozone and well-anchored long-term inflation expectations, a more aggressive normalization pace as implied by markets seems unlikely. In 2023, the hiking cycle is likely to end as slowing growth and rising Eurozone fragmentation risks weigh on the ECB's normalization plans. Moreover, with the Fed likely to hit the pause button on its hiking ambitions in 2023, it will become harder for the ECB to swim against the tide and continue raising rates. Therefore, we only pencil in two rate hikes for 2023 – both of which should take place in the first half of the year. With the effective policy rate at 1.25%, the ECB would reach the mid-point of estimates for the neutral rate. If Italian spreads widen to 350bps, we expect the ECB to intervene in markets to fight fragmentation risks, albeit without any conditionality attached. As a reminder, Outright Monetary Transactions were introduced when Italian spreads stood at 500bps.

Germany: Industrial sector - Achilles' heel in 2022, growth driver in 2023.

In line with our expectations, the German economy grew +0.2%q/q in Q1 2022, beating other Eurozone economic heavyweights, including France and Italy, even as GDP levels remain -0.9% below pre-Covid levels. However, growth prospects have deteriorated significantly following Russia's invasion of Ukraine, which put an end to the unfolding industrial recovery. In fact, in the near-term, Germany's large industrial base remains a key vulnerability amid prolonged supply-chain disruptions – notably in the car sector, which represents around 15% of total industrial production – a strong dependence on Russian energy and subdued Chinese growth momentum. We only expect German industrial production to emerge from the summer recession in the final quarter of the year as supply-chain disruptions emerging from China's zero-Covid policy start to ease, providing a tailwind to German export dynamics. Private consumption will only grow moderately over the forecast horizon – with the exception of a temporary post-lockdown summer rebound in 2022 – amid higher-for-longer uncertainty and inflation (6.8% in 2022 and 3.2% in 2023). Overall, we expect the German economy to grow by +1.7% in 2022 and +1.4% in 2023.

France: The energy crisis is weighing on growth momentum, but factors of resilience remain.

French GDP unexpectedly contracted in Q2, weighed down by slumping consumption, but investment momentum remained solid. We expect the pace of activity to be moderate over the next quarters as elevated inflation will further take its toll on the purchases of big-ticket items. However, high-frequency indicators suggest that spending on services is increasing at a fast clip. A high capacity-utilization rate and a large backlog of orders in the manufacturing sector should continue to support business investment spending in the months

ahead, despite an increasingly challenging external environment. Corporates continue to hire at a healthy clip and forward-looking indicators suggest that the pace of net job creation should remain solid. Despite low consumer confidence, a tight labor market is helping to cushion the blow from higher energy prices for households since a larger proportion is receiving an income. On the housing market, permits and starts are trending upwards despite elevated construction costs, owing to a structural shortage of residential spaces and still low mortgage rates. Overall, loose fiscal policy, a solid business investment, a tight labor market and a recovery in export volumes will support French GDP in 2022, which we expect to grow by +2.5%. However, headwinds from ECB-induced tighter financial conditions, a less supportive fiscal stance and a further squeeze in real wages will limit GDP growth to +1.5% in 2023.

Italy: Mind the return of political uncertainty in H1 2023!

Thanks to a solid carry-over, we still expect GDP to grow by +2.6% this year. Q1 2022 GDP growth was revised up by 0.3pp to 0.1% q/q, allowing output to return to pre-pandemic levels. However, Italy's output gap remains large and current growth dynamics suggest that a contraction will be harder to avoid, especially if the embargo on Russian energy exports is widening. Prolonged supply-chain disruptions, high input costs and elevated uncertainty will weigh on industrial production after a decline of 0.6% y/y in Q1. Private consumption should remain subdued at best as the EUR8bn fiscal package put forward in May will fail to fully cushion the impact of the energy price shock on households and corporates. On top of the current crisis, political elections next year will add challenges to Italy's economic outlook. According to voting intentions, the current national coalition government could struggle to secure another term as fragmented views persist. Moreover, the right-wing Eurosceptic party Brothers of Italy is leading the polls at 22% and will likely play a major role in shaping the next government, which could complicate Italy's role in reaching consensus on important EU projects, such as the completion of the banking and capital market unions, but also on the implementation of the NGEU-related reforms. Political stability will be crucial in the coming years to ensure credible fiscal consolidation, effective implementation of structural reforms and a timely allocation of funds related to the NGEU.

Spain: GDP will not return to its pre-pandemic level before Q1 2024.

Despite entering 2022 with strong economic momentum – the economy expanded by +0.3% in Q1 2022 after +2.2% q/q in Q4 2021 - Spain's GDP still stood more than 3% below pre-crisis levels at the beginning of the year. Unfortunately closing the remaining gap will prove challenging in light of mounting economic headwinds. We expect growth momentum to prove modest at best amid sky-high inflation (7.5% in 2022 and 3.5% in 2023), heighted geopolitical uncertainty und prolonged supply-chain disruptions. The main driver of growth in the coming months will be the revival in social spending – above all tourism. Private consumption – which still stands almost 10% below pre-pandemic levels – is unlikely to make a notable contribution to growth as the significant hit to household purchasing power amid a sharp decline in real wages will weigh on spending decisions. In the second half of the year, we expect economic growth to accelerate, given a faster implementation of RRP funds. Overall, we expect GDP to expand by +3.9% in 2022 and +1.9% in 2023. Amid expensive fiscal support measures and a general election scheduled for H1 2023, fiscal consolidation results are likely to prove modest over the forecast horizon.

UK: At least two quarters of negative growth in 2022.

Given the current soft economic data, we believe increasing interest rates to 3% would be almost impossible for the Bank of England, which reacted to the negative GDP growth readings in March and April by falling behind the Fed with a 25bp rate increase in June (to 1.25%). Indeed, increasing interest rates to 3% would mean that GDP is 2% lower compared to initial conditions, pushing the economy into recession in 2023. The peak in inflation is expected in Q3 at 12%. Inflation is likely to average 9.5% over the year before falling to 4% by summer 2023. Despite a fiscal package equivalent to 1.7% of GDP to cushion the rising cost of living, we still expect consumers to sizably slow down spending and companies to slow down investments, pushing GDP growth into negative territory in Q2 and Q4 (-0.3% q/q). Hence, we expect GDP growth to slow down to +1% in 2023 after +3.2% in 2022. In this environment, we believe it will be hard for the BoE to go beyond 2% in rates at end-2023.

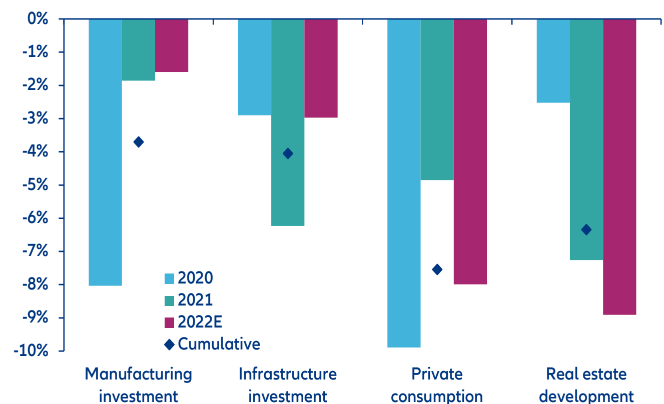
Emerging Markets

China will maintain its zero-Covid policy through 2022, but the worst of the latest outbreak is likely behind us. Provinces and cities under partial or full lockdowns accounted for nearly 25% of GDP in March-April (compared with 18% during the worst week in August 2021, and 63% during the worst 20 days of 2020 across January and February). However, this share fell to just 9% in May and 5% in the first half of June. A return-to-normal in mobility at the national level is likely in July, barring renewed large-scale Covid-19 infections and lockdowns, and based on the post-lockdown experiences observed in 2020.

We expect China's 2022 GDP growth at +4.1%: A post-omicron economic recovery lies ahead, but it will likely be mild and risks are on the downside. We are revising down our 2022 forecast (from +4.6%), while the forecast for 2023 is revised slightly up to +5.2% (from +5.0%). Risks are skewed to the downside, with renewed Covid-19 outbreaks in the zero-Covid policy framework and geopolitical tensions with the US potentially weighing further on growth. An upside surprise could come from larger-than-expected policy support. In our baseline scenario, GDP is likely to contract in Q2 2022 (-1.4% q/q), before a recovery in H2 on the back of some normalization of external activity and policy support domestically. That said, the V-shaped post-Covid rebound of 2020 is unlikely to be repeated as the context is different this time round. Exports could see a short-term boost, thanks to the normalization of Chinese port activity in the coming two-three months[4], but external demand for goods is not as strong as it was in 2020-2021. Domestically, the real estate sector continues to struggle. A further deterioration will be avoided, thanks to the targeted easing of policy measures (e.g. purchase rules in some cities, lower mortgage rates for first-home buyers etc.), but other non-systemic credit events are likely and a full rebound at the national level is unlikely. For private consumption, a return to the pre-pandemic normal is not on the cards either in 2022 as the government maintains the zero-Covid policy that weighs on consumer confidence and the unemployment rate remains at a high level. We estimate that private consumption is likely to remain 8% below the pre-pandemic trend in 2022. Conversely, other areas of the economy, particularly manufacturing and infrastructure, are likely to fare better and drive the upcoming economic recovery. The former is supported by some normalization of trade activity, while the latter reflects an accommodative policy mix.

[4] See our report A trade recession before a mild Chinese reopening?

Figure 17: China: Distance from pre-pandemic trend (%)



Sources: Official sources, Allianz Research

A significant easing in the zero-Covid policy and potential reopening of borders could start in Q2 2023. China's policy environment in the coming months will be punctuated by crucial political events: the CCP's 20th National Congress, likely to occur around November, will announce the party leaders for the coming five years and the plenum in March 2023 will officialize top state positions. Policymakers will likely aim for stable and managed economic and sanitary situations in the run-up to these events. This means that further policy measures to support short-term growth are likely, amidst a zero-Covid policy that is likely to be maintained. Judging from the pace of vaccination in the past months and taking a modest assumption (i.e. 0.2% of the population aged 60 years old or more receiving a booster shot every week, vs. c.1.5% on average in April), a sufficient level of immunity (75% vaccination rate among this population) could be reached in April 2023. It is thus possible that China only starts significantly easing its zero-Covid policy and potentially reopening borders in Q2 2023.

Policy easing is stepping up, especially on the fiscal side, as monetary stimulus sees some roadblocks. The policy stance in China has gone against the trend of the rest of the world since last year. After tightening for the larger part of 2021, monetary policy has quickly reversed back to easing mode since Q4 2021. The fiscal policy is likely to ease further. The annual quota for local government special bonds (which are dedicated to infrastructure investment) has been kept at RMB3,650bn for 2022 (c.3% of nominal GDP), with fast issuance (at a similar pace than in 2020) already observed year-to-date. Further fiscal spending could be financed through

central government special bonds. Additional measures amounting to 1.3% of 2022 nominal GDP include tax credit rebates, a postponement of social security contributions for certain companies, policy bank support, the 2023 budget being partly frontloaded etc. In total, we estimate that fiscal stimulus in 2022 would amount to around 2pp of GDP, compared with nearly 6pp in 2020. On the monetary side, the central bank has implemented rate cuts, liquidity injections and a targeted relaxation of some macroprudential measures since Q4 2021. Going forward, with inflation pressures contained, we expect the PBOC to keep an accommodative monetary policy by keeping interbank rates low through liquidity operations. That said, no more policy rate cuts are likely in 2022, in part to avoid excessive downward pressure on the currency. Finally, the regulatory environment also seems to be relaxing (e.g. regarding tech companies), although a return to pre-pandemic times is unlikely.

Weakening growth and persistent high inflation on the horizon in Emerging Europe. Economic momentum held up well at the beginning of the year. Q1 GDP growth in the CEE-EU-11 (the 11 EU member states in the region) came in stronger than expected at +2.3% q/q (+6.9% y/y). However, early indicators suggest that activity began to slow down in Q2. Russia's economy has not yet crashed and Turkey's real economy seems to have adapted to the high-inflation environment, for now. Going forward, we expect activity to weaken in H2 and some economies are likely to enter recession, especially Russia as the effects of the war and sanctions hit harder. But spillovers from the war in Ukraine may also cause a downturn in the Baltic states due to their proximity to Russia, as well as in Czechia and Slovakia whose large car industries are also being battered by ongoing supply-chain disruptions. Fiscal stimulus and strong wage growth should help Poland, Hungary and Romania to outperform in terms of growth in 2022, but rising macroeconomic imbalances make them also more vulnerable to aggressive global liquidity tightening and pressures on their currencies. We have revised our forecast for real GDP growth in the CEE-EU-11 to +3.9% in 2022 (compared to +3.4% in March) followed by +2.9% in 2023 (unchanged). In Emerging Europe as a whole (including Russia but excluding Ukraine), we project a recession of -0.7% in 2022 (-1.1% in March) and modest growth of +0.7% in 2023 (+0.9%).

Meanwhile, surging energy and food prices have pushed up inflation across the region and we project new multi-year highs in the next months. Price growth should remain well above targets in 2023. We expect CEE central banks to continue to hike policy interest rates to the range of 6-8%. In contrast, central banks in Russia and Turkey are likely to cut interest rates further to support growth. In Russia, this is justified for now, thanks to easing inflation pressures. But Turkey urgently needs massive rate hikes in order to rein in the slump of the TRY over the past months. As the country's external position has become dire and Turkish policymakers do not appear to opt for rate hikes, the likelihood of full-fledged capital controls being implemented over the next few years has risen. In any case, a sharp economic downturn is highly likely at some point in 2022-2023.

We expect GDP growth for Emerging Asia excluding China to reach +6.5% in 2022 and +6.3% in 2023 (after +8.3% in 2021 and -2.7% in 2020). This implies downward revisions for both years (-0.6pp in 2022 and -0.4pp in 2023) but masks different sets of stories across the region. After suffering more due to the pandemic in 2020-2021, Southeast Asian economies should benefit from a larger catch-up effect in 2022 on the back of high levels of immunity and a relatively larger easing of sanitary restrictions. Net commodity exporters (e.g. Indonesia and Malaysia) should also benefit from higher global commodity prices. In addition, being later in the economic recovery cycle, Southeast Asian economies are seeing relatively lower inflation rates compared to other emerging countries, which has allowed their central banks to start the rate-hiking cycle later (e.g. Malaysia and the Philippines in May, Thailand and Indonesia likely in Q3). The growth-inflation trade-off has thus remained favorable for comparatively longer. As a result, we expect GDP for the ASEAN aggregate to accelerate in 2022, growing by +5.2% (vs. +3.2% in 2021), roughly in line with the pre-pandemic average. Conversely, the quasi-developed economies group of South Korea, Taiwan, Hong Kong and Singapore should see a lower rate of GDP growth in 2022, with the aggregate forecast at +2.8% (vs. +5.3% in 2021 and a pre-pandemic average at +3.5%). This is due to stringent Covid-19 policies that have been kept for longer (e.g. Hong Kong and Taiwan to a lower extent), central banks that started to tighten monetary policies earlier (e.g. in August 2021 in South Korea), and an external demand context that is less favorable than in 2021. That said, exposure to sectors with tight supply (e.g. electronics) and the upcoming normalization in activity in China should be supportive for the economic outlook of these export-oriented economies for the rest of the year. Going into 2023, we expect growth to come down across the Emerging Asia region, though it should remain robust compared to other emerging market peers.

Latin America faces a mixed outlook, with short-term tailwinds (commodity exports) and medium-term headwinds (inflation, fiscal space and political risk). The challenging geopolitical context clearly favors the many net commodity-exporting countries - mainly those that export energy and agrifood - located in the region, such as Brazil, Colombia, Bolivia and Ecuador. In addition, for about a year now, many central banks in the region have been raising interest rates to fight inflation, a critical point in LatAm due to the memory of hyperinflation. As a result, the region currently offers high interest rates, an attractive factor in the current environment of monetary tightening by major central banks, especially the Fed. In this sense, the short-term outlook for these countries has improved. Indeed, rising commodity prices have boosted their terms of trade - the ratio between the price of exports and the price of imports. This has helped support economic growth and improve balance of payments positions, while higher revenues also contribute to enhance their fiscal positions. Together with resilient domestic economic activity, this will lead to stronger-than-expected economic growth for some countries in 2022, such as Brazil (+0.9% versus +0.2% previously) and Colombia (+6.1% versus +5.6% previously). For the region as a whole, we expect economic growth at +2.1% in 2022 (versus +1.7% previously).

Inflation has been persistent, which has led us to revise our forecasts upwards for both 2022 and 2023 (12.8% and 8.3%, respectively). This also had implications for the hiking cycle, which was extended in 2022 (e.g. we expect the Brazilian Central Bank to move the Selic rates to 13.75% , up from 13.25%, previously). Given higher inflation as well as higher interest rates in the US, we consider that there is little room for significant interest rate cuts in the region next year. All in all, we expect the effects of the strong monetary policy tightening to be felt throughout 2023, which will affect both private consumption and investment.

Recent political shifts in several key economies (Peru, Colombia) towards less traditional, anti-establishment governments have substantially increased uncertainty over the direction of economic policy, creating volatility. We also expect political instability to rise in Brazil in the second half of the year due to the upcoming presidential elections (in October) as the current far-right president and candidate, Jair Bolsonaro, has raised doubts about the electoral process. In general, we note that the policies of both current and new governments suggest greater pressures to increase social spending, especially in the environment of high inflation in energy and food prices, which tends to increase discontent in the region (clearly the case in Peru in recent months). Thus, we can expect less rigidity on the fiscal side, which, combined with the recent significant increase in interest rates, implies a larger fiscal deficit. While the terms of trade give some breathing room in the short term, the fundamentals remain vulnerable, especially for Brazil on the fiscal side. All in all, we have revised our growth forecasts for the region downwards for 2023 (+1.4% versus +2.0%, previously).

The war in Ukraine is having mixed effects on the Middle East.
On the one hand, most economies in the region are heavily reliant on grain supplies from Russia and Ukraine via the Black Sea, the export route that is now effectively shut down by restrictions related to the war. Moreover, the recovery in tourism may also be affected by the war. On the other hand, higher global oil and gas prices and demand for alternative sources of hydrocarbons will provide short-term fiscal and export profits to the GCC economies as well as Israel, whose gas production is gaining momentum. This coupled with the strong policy response during the pandemic will support growth prospects. Consumer prices in the GCC and Israel left deflationary territory in 2021 and we expect inflation to remain positive but not excessive until end-2022. Elsewhere in the region, higher inflation and tighter fiscal policy will weigh on growth. Overall, we forecast real GDP in the Middle East to grow by around +5.1% in 2022 and +3.1% in 2023.

Africa: little room for maneuver and increased risks of food insecurity.
The war in Ukraine comes at a time when several countries on the continent are facing extremely limited fiscal space. Debt was already a growing problem across all income groups of African countries prior to Covid-19 and it was exacerbated by the pandemic. Public debt relative to GDP is at an all-time high and little or no relief is expected in the near term. In addition to the cost of subsidizing fuel, fertilizer or food products, which is expected to rise sharply due to high commodity prices, recent flooding in South Africa and a severe drought in East Africa will likely prompt a fiscal response as the authorities step in to support relief and reconstruction efforts. Adverse external conditions through tightening global financial conditions and enduring conflicts have weighed on economic growth, but so have unfavorable domestic conditions such as a new Covid-19 wave, high inflation and rising interest rates. Commodity-exporting countries (e.g. Angola, South Africa, Nigeria) have a more positive outlook, helped by better terms of trade prospects. Note, however, that domestic issues are limiting growth: for instance, energy rationing and logistical bottlenecks in South Africa, aggravated by flood damage to the port of Durban in April; the struggling oil sector in Nigeria. Inflation is set to continue increasing, driven by costlier food and fuel prices. We note

heightened food security risks in North Africa and many parts of sub-Saharan Africa where the role of agriculture and the tendency to rely on imported food products make countries particularly vulnerable to the agricultural shock caused by the geopolitical conflict. In Egypt and Tunisia, the war in Ukraine has further added to external liquidity and debt risks as the countries are net food importers, heavily dependent on grain imports from Ukraine and Russia. Somalia, Ethiopia, Eritrea, Djibouti and Sudan are also heavily exposed to wheat supplies from the war region. Meanwhile, Côte d'Ivoire, Ghana and Kenya are the most dependent on sunflower oil from Russia and Ukraine. In light of the different challenges, we have revised growth expectations for the region down to +3.1% (from 3.4% previously) and raised our inflation forecasts to 13.9% (+1pp).

Capital markets outlook

Central banks' ability to fight record inflation without causing a recession will increasingly depend on the resilience of capital markets. The abrupt readjustment of short-term policy rate expectations has translated into a broad-based market correction across virtually all asset classes; this suggests diminishing investor confidence that inflation will abate without a significant slowdown in economic activity. Besides some well-known and much discussed headwinds (monetary policy normalization in the US and in the Eurozone, zero-Covid strategy in China, impact of the war in Ukraine on consumer and business confidence), recent changes in monetary aggregates confirm that recessionary risks have increased. After a period of monetary expansion, global money growth (as measured by a Fisher index) continues to slow. In March, global M3 and base money grew by under +10% (against +13.5% and +35.5%, respectively, in February 2021). In the largest economies, money velocity has (at least so far) failed to rise in response to rising inflation. Going forward, the interaction of the monetary stance and capital markets will be critical at a time when tightening financial conditions removes central banks' "put option" for risky assets, while bonds lose their traditional function as a hedge amid expectations of rising rates.

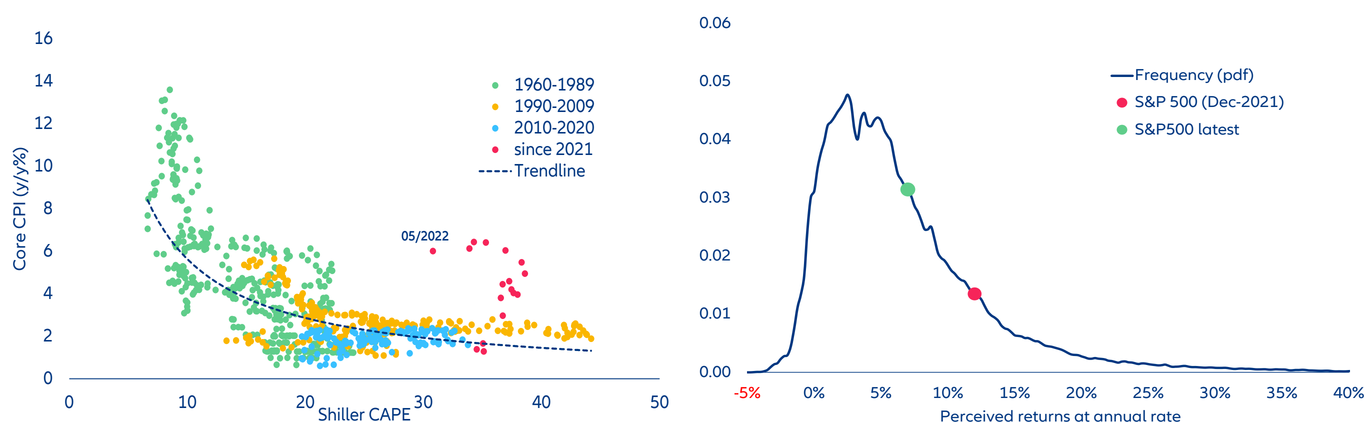
Figure 18: Global monetary base

Source: Allianz Research

Recent changes in the benchmark yield curves suggest that current rate expectations entail significant recession risk and continue to be extraordinarily sensitive to the monetary stance. The abrupt repricing in money market futures has dramatically impacted the long end of sovereign yield curves, leading long-dated bonds to have one of the worst starts to a calendar year in decades. US money market and swap curves are already largely inverted, and the Euro curve is flattening strongly, especially in real terms. Markets have already priced in a reversal of the current hiking cycle in the US, with a first rate cut expected as early as H2 2023. The main driver of changes in the interest rate term structure has been shifting from the risk component (term premium) to expected short-term rates. Thus, current rate expectations might have overshot, with long-term rates expected to stabilize at 3.2% (10Y US Treasuries) and 1.5% (10Y German Bunds) by the end of 2022. In 2023, we forecast a further decline to 2.9% and 1.2%, respectively, as economic activity slows and inflationary pressures fade. Thus, for the foreseeable future, we leave behind the episode of ultra-low interest rates, which was mainly based on the compression of the term premium by Quantitative Easing. In our adverse scenario, when central banks keep raising rates beyond the neutral rate in response to unrelenting inflationary pressures, long-term yields could rise even further in 2022, but would then fall sharply back to 2.2% and 0.2%, respectively, in 2023 because of a strong recession and the resumption of QE (at least in the Eurozone).

The recent "hawkish" money market rotation has not spared risky assets. Global equity markets sold off, with most markets trading within or close to bear market territory (20% lower over the year) and significantly down from their 2021 highs. Within the sell-off, the bearish cocktail has been harsher on the 2020-2021 leaders and on those sectors most sensitive to changes in short-term interest rates (i.e. technology) due to their long-duration cash flow profiles. Because of this, growth and cyclicals have underperformed value and defensives, with growth/cyclical-heavy indices (i.e. S&P500, Nasdaq, FAANGs etc.) underperforming their equally weighted counterparts. Within sectors, consumer staples (a recession-resilient sector) has outperformed consumer discretionary (a recession-vulnerable sector), reinforcing the idea that equity markets are recursively pricing in the increased probability of a deeper-than-expected recession in 2023 (Figure 19).

Figure 19: US equities: price-to-earnings ratio relative to core inflation and distribution of perceived returns of S&P500 equity index



Sources: Shiller, Refinitiv Datastream, Allianz Research

Note: pdf = probabiliy density function

Equity valuations still have room to drop further, especially if overshooting inflation forces central banks to become even more hawkish. Rising real rates due to tightening financing conditions have lowered the earnings multiples equity investors are prepared to accept, which has weighed on valuations. In a historical context, however, the bottom has not been reached. For the US, a further correction by 20-30% from current levels would restore a steady state price-to-earnings ratio of about 15. The cyclically adjusted earnings yield of the S&P 500 remains historically low (2.9%). Everything else being equal, it should be close to 3.2% to 3.3%: leaving aside earnings forecasts, the S&P 500 appears to be 10 to 15% overvalued. From a momentum point of view and using perceived returns as metrics, unlike a few months ago, the leading indices (NASDAQ 100 at 13.9%, NASDAQ at 11.5%, S&P 500 at 9.1%) are no longer in bubble territory (i.e. above 15%). Following the bursting of a bubble, broad indices typically reach a trough (an anti-bubble) when their perceived returns fall to low single-digit levels, if not below zero. Despite their recent corrections, equity markets have not yet reached the levels where the distribution of potential outcomes would become skewed to the upside. US equity markets seem to still have some room for a further correction as the last 10-year bull run had left valuations close to Dotcom bubble levels. Interestingly, this is not the case for the Eurozone as current valuation metrics show EUR equities being relatively cheap. However, and despite the relative cheapness, the proximity to Ukraine, elevated inflation and the expected withdrawal of ECB support may still lead to temporary downside corrections until year-end.

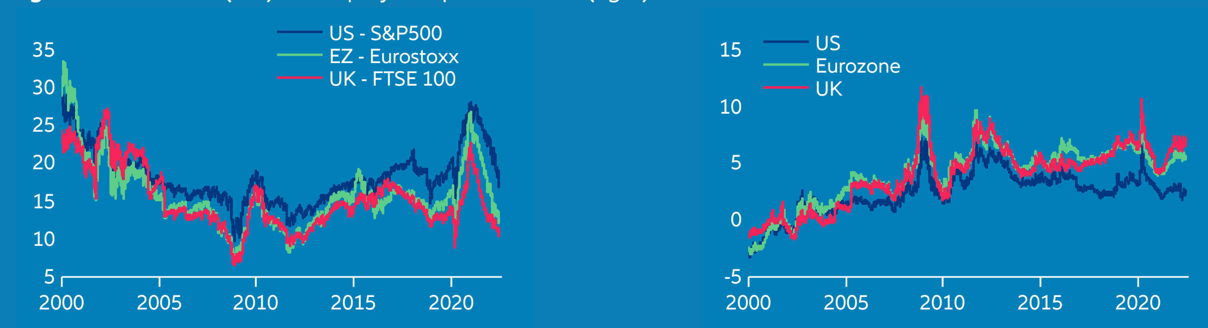
But even if PE ratios start to point towards a relative "cheapness", the market-implied equity risk premium gives no reasons for optimism. Historically, both EUR and US equity risk premiums appear to be low, i.e. equities look expensive vis-a-vis bonds, with investors not having the prospect of a high return for the risk they are implicitly taking. However, if we expand the time frame beyond the 2008 financial crisis, ERPs look relatively high and point to a relatively high value for the risk taken vis-a-vis sovereign bonds. Other "high" inflation periods suggest that slowing inflation from high levels tends to be a good tailwind for equity markets, pushing the ERP down for as long as companies manage to deliver decent top and bottom-line results, and thus suggesting that equity markets should enjoy some cushioning effect towards year-end and especially in 2023 (Figure 20).

Despite the significant corrections in equities, markets have remained relatively calm compared to previous stress episodes. Even as US stock markets entered bear market territory two weeks ago, with the S&P hitting a new 52-week low, the sell-off has not structurally prompted forced liquidations and margin calls that tend to self-reinforce and cause broader market turmoil. The most common volatility metric, the VIX, did not signal the kinds of market distress caused by the onset of the Covid-19 crisis in March 2020, the global financial crisis or the US debt downgrade in 2011 (Figure 21). It seems that there has been a quite orderly adjustment of markets to the new normal of an aggressive monetary stance to tame high inflation rates, with an uncertain impact on economic growth.

Only commodities and precious metals have outperformed this year so far. The combination of the war in Ukraine and the third round of lockdowns in China have triggered a persistent increase in commodity prices, averaging a ~80% year-to-date return. In addition, gold is still trading in the green as recessionary fears and a continuous rotation to safety push the precious metal up. Interestingly, due to its underlying sector composition, which overweights commodities and defensive sectors, the UK equity market has outperformed the broader equity market (Figure 23).

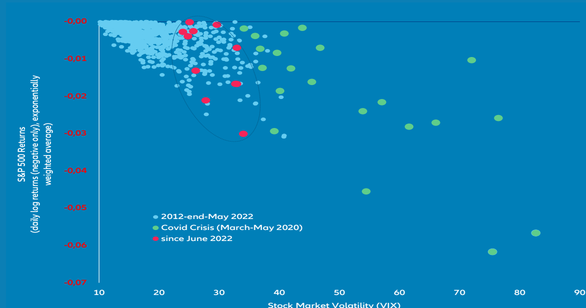
Equity markets will remain under pressure in 2022 due to higher inflation and lower growth weighing on corporate margins. The market correction over the recent months confirmed that inflation overshoots are credit negative, with adverse effects on valuations. Within the inflation-equity conundrum, equities are currently located within the edges of the inflation hurricane, signaling that the current unstable equilibrium allows for a further equity market correction should inflation fail to abate quickly (Figure 24).

Figure 20 : PE ratios (left) and equity eisk premium in % (right)



Sources: IBES, Refinitiv Datastream, Allianz Research

Figure 21 : US equities: daily returns and stock market volatility (only days with negative returns)

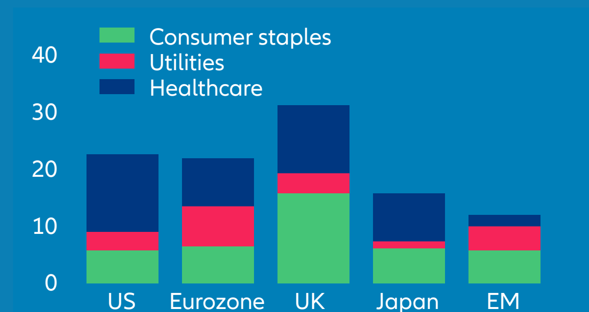


Sources: Refinitiv Datastream, Allianz Research

Figure 22 : Cross asset performance year-to-date 2022 (All in local currency otherwise stated)

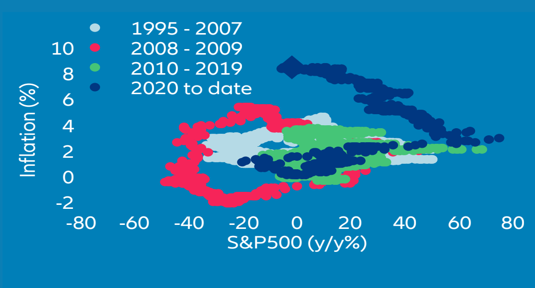
Sources: Refinitiv Datastream, Allianz Research

Figure 23 : Share of defensive sectors in stock market capitalization



Sources: Refinitiv Datastream, Allianz Research

Figure 24 : US Inflation hurricane of the equity-inflation nexus



Sources: Refinitiv Datastream, Allianz Research

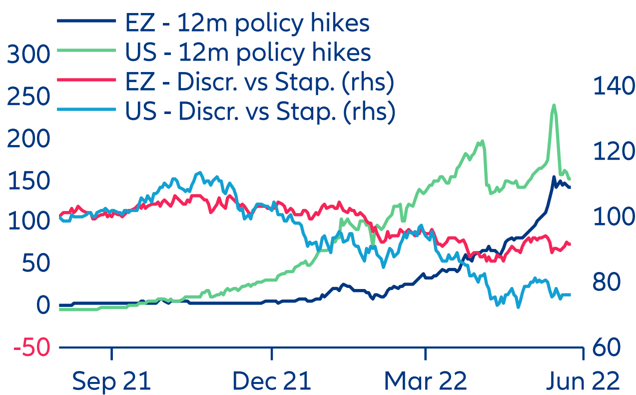
Risk appetite in equity markets has been driven by the continuous repositioning in money markets to the changing future monetary policy path. As long as inflationary pressures imply uncertainty about future policy rate moves, we expect equity markets to stay in bear market territory (i.e., prices to stay depressed by more than 20% relative to the beginning of the year). Markets will also increasingly factor in a higher probability of a recession, with consumer staples outperforming consumer discretionary. The recent over-performance of value and defensives over growth and cyclicals is expected to continue until year-end with commodity-based equity sectors outpacing the rest of the market (Figure 25).

Our decomposition model underscores that high inflation has an increasingly adverse impact on equity performance. Interestingly, the last time we had such a divergence between actual equity performance and modeled performance was right before the 2008 financial crisis and the Euro crisis, two points in time in which equity market sensitivities to macro developments also inverted. This divergence confirms the current market positioning for a recessionary environment (Figure 26).

We have revised down our year-end forecasts for both US and European equities to -15% and -9%, respectively. This revision affirms our relatively milder-than-expected economic landing, lower-than-expected policy rates and higher-than-expected corporate balance sheet resilience. Despite the downside correction, the scenario still allows for some timid upside towards year-end and especially in 2023, with target performance rates for both the US and the Eurozone at +7% and +5% in total return terms, respectively, and in sync with the gradual decline in economic and policy uncertainty. In our adverse scenario, we would expect equity markets to enter into a full-fledged bear market territory with -28% and -23% for 2022 in the US and Eurozone, respectively. After the market sell-off, and well within 2023, we would expect a decent market recovery as central banks cut back interest rates and some central banks restart policy support. In this scenario, we would target +15% and +10% for the Eurozone and US in 2023, respectively.

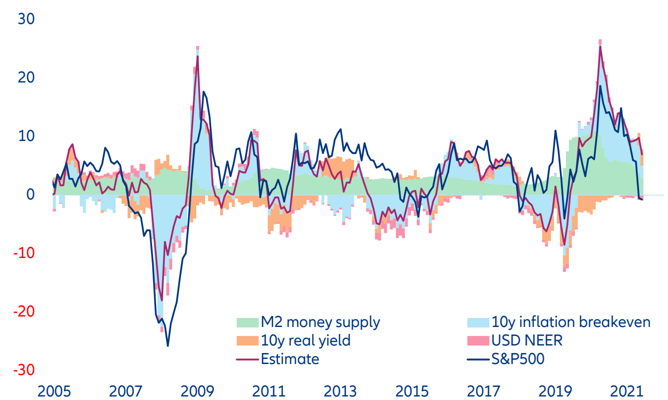
Tightening financing conditions and recessionary concerns have led to a structural widening of corporate credit spreads but they remain highly resilient from a historical perspective. The early repricing of monetary policy expectations has led to a substantial repricing of corporate credit risk, a relevant slowdown in primary markets and an increasing share of corporate bonds trading below par. The move has been more violent within high yield, where the expectations of higher financing costs have almost brought the primary market to a halt. Surprisingly, and despite the increase in credit risk pricing and broad outflows, credit spreads have widened less than expected as the “whatever it takes” put protection has remained present in the mind of corporate credit investors and has exacerbated the resilience of corporate credit risk to equity market volatility. To put this into context, in recessionary or close to recessionary periods, one would structurally expect a -1% decline in equity prices to lead to a 6-to 8bps widening of EUR investment grade corporate spreads. Today, this relationship indicates that for a 1% decline in equity prices only 2.5bps are added to corporate spreads. All in all, credit spreads are currently not consistent with the equity bear market (Figure 27).

Figue 25: Market-implied policy rates and equity sector rotation (bps and reb.100)



Sources: Refinitiv Datastream, Allianz Research

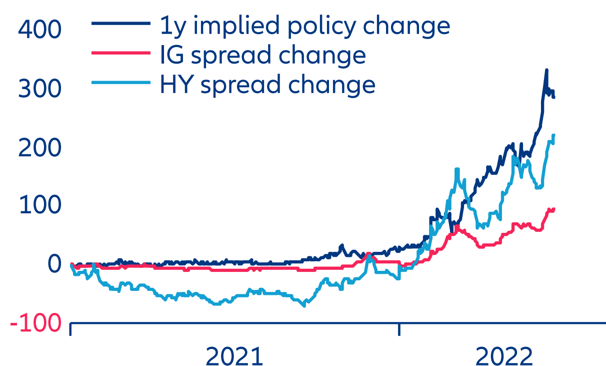
Figure 26: US equities decomposition model



Sources: Refinitiv, Allianz Research

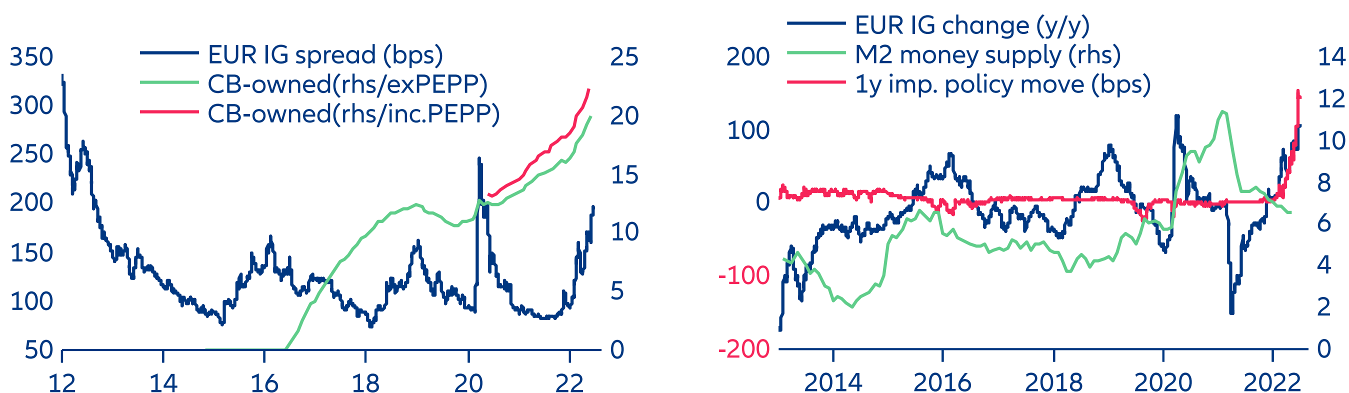
At the same time, the gaps between rating buckets has widened at a distressing pace as credit investors have ramped up the credit quality of their portfolios. European credit initially suffered relatively more due to its higher exposure to geopolitical risks (energy, supply chains). The retreat of the ECB as a purchaser of corporate bonds has led to a shrinking in primary market volumes, with HY issuance being close to negligible.

Figure 27: EUR Policy expectations vs corporate credit (bps – corporate spread changes since Dec. 2020)



Sources: Refinitiv, Allianz Research

Figure 28: ECB ownership of corporate (left) and Eurozone money supply (right)

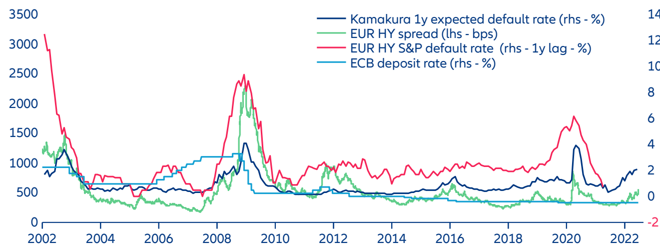


Sources: Refinitiv Datastream, Bank of America, Allianz Research

Despite the recent resilience, the asset class is not yet out of the woods. A steeper-than-expected policy rate path and slowing growth could lead to a rapid repricing of credit risk, especially in the high-yield segment. This is especially true as the implied market default probability of corporate credit remains slightly elevated despite the still contained credit spreads, with default rates remaining extremely low (lagging by one year) and indicating that credit risk will remain under pressure during 2022 and 2023, with some HY companies struggling to issue new debt. In fact, we are starting to see some market cracks within lower-rated buckets as market volatility remains high and financing standards tighten (Figure 28). Debt-servicing metrics and net leverage metrics remain relatively high, showing that the recent market resilience may not be fully unjustified. However, this is expected to hold true if the current inflation and policy push proves temporary as a longer-than-expected inflationary environment will quickly break the current resilience (Figure 29).

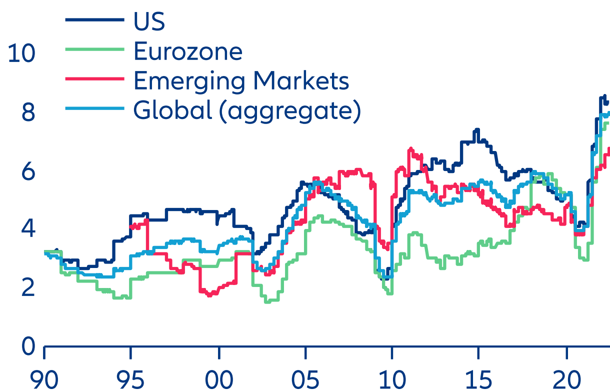
A macro-driven approach to explaining changes in corporate spreads suggests that a decline in the growth rate of monetary aggregates adds further widening pressure to corporate spreads. We expect corporate spreads for both HY and IG credit to remain under pressure for the rest of the year (Figure 30) but range-bound at between 160 to 170bps; however, short-term volatility due to money market repositioning could lead to a temporary overshoot of our predicted year-end target level in both the US and Eurozone. In 2023, and as the corporate credit market stabilizes in sync with inflation and monetary policy, we would expect IG credit spreads to compress in the order of 20 to 30bps. However, in our adverse scenario, we would expect corporate spreads to widen to levels last seen during the onset of the Covid-19 crisis as higher policy rates and inflation will lead to a sharp repricing in defaults and rising credit risk.

Figure 29: EUR HY spreads vs probability of default and ECB rate



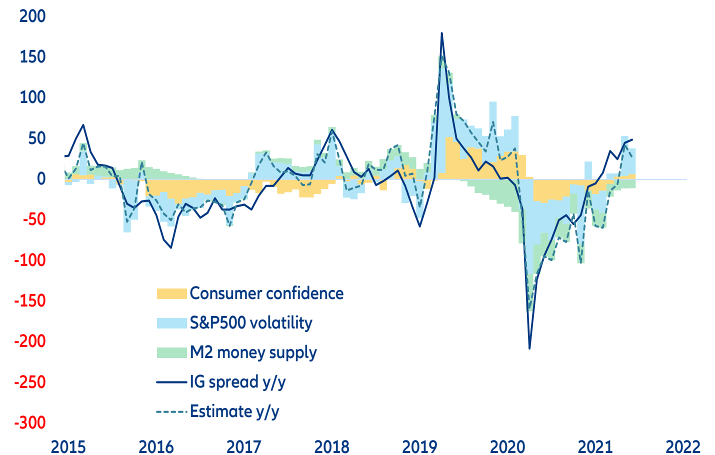
Sources: Kamakura, S&P, Refinitiv, Allianz Research

Figure 30: Debt servicing ratio



Sources: Refinitiv, Allianz Research

Figure 31: Credit spread decomposition (y/y - bps)

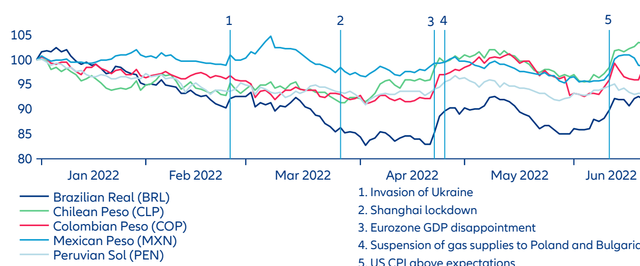


Sources: Refinitiv, Allianz Research

Emerging markets remain under pressure due to the combined impact of tightening financing conditions globally and rising growth concerns weighing on external demand. These headwinds keep us on the "bearish" side. Net capital flows have nearly ground to a halt as borrowing costs are set to increase. In our adverse scenario, default risk could become a serious problem for several EM countries and companies alike.

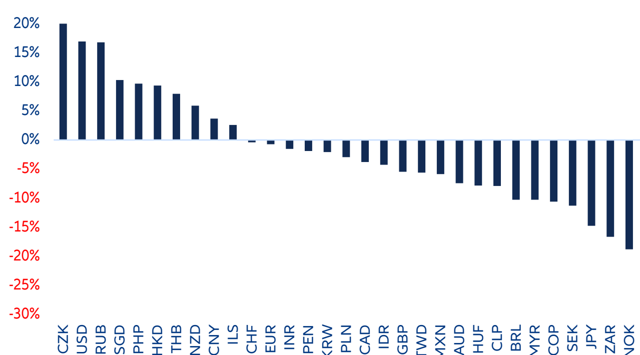
The upside potential for commodity exporters is transitory. While investors have become more cautious towards EM assets, we have noticed that countries that offer high carry and are net exporters of commodities have stood out. Countries in the LatAm space have been favored, with a clear appreciation of currencies after the beginning of the Russia-Ukraine conflict (Figure 31); the Brazilian Real (BRL) has been the second best-performing currency of the year, gaining +10% against the US dollar. That said, the overall effect on the currency market has been distorted by factors associated with general risk sentiment and the strong movement of the USD, and currencies of commodity-exporting countries remain extremely cheap according to our valuation models (Figure 32). In this sense, a normalization of market sentiment and high commodity prices offer scope for a further appreciation of commodity currencies in the year. That said, we expect that for some countries, such as Brazil and Colombia, this effect may be short-lived due to the high risk of political instability and/or low growth expectations.

Figure 32: USD-denominated debt: maturity vs. relative size



Sources: Refinitiv, IIF, Allianz Research

Figure 33: FX valuation



Sources: Refinitiv, Allianz Research

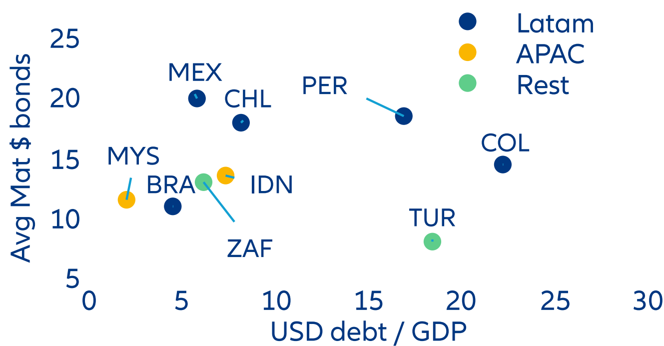
We expect a further correction in both local and hard currency EM sovereign debt. In the case of the latter, and given the oil-skewed country composition of the reference index, we expect spreads at around 370bps at the end of 2022 (currently at 363), a level that would moderately decline through 2023 (340bps expected for year-end). In the adverse scenario, we could see much higher spreads. Our expectations are for 650bps and 600bps in 2022 and 2023, respectively, with potential maximum drawdowns above 700bps.

Leaving aside index aggregates, the effects will be asymmetric within the EM spectrum. Among the big ones, Turkish debt is the one going through a more distressed period. Turkish bonds – and the associated credit default swaps – have responded to this and it is now becoming increasingly expensive for the country to issue foreign-denominated debt (before September ends, USD5.5bn of this debt are maturing), while the foreign investor has almost left the local currency spectrum.

The outlook is not better for the local currency environment. In our baseline scenario, the reference yield, which has also already increased rapidly since post-Covid lows following the inflation hit, will end the year higher (7.5% from current levels around 7.2%) to recover modestly in 2023 (around the 7%). In the adverse scenario, yields could increase by another 150bps compared to the baseline, with temporary pick-ups that could see them getting closer to the 10%.

EM equities are affected by the same triad, but geopolitical instability is particularly acute, with growing concerns about investing in China's. Although Chinese equities have become a diversification tool, given their relatively endogenous-driven cycles, in this particular case both exogenous and endogenous factors point towards a bumpy performance, so the odds are not in their favor. The high east-Asia concentration, which also means a greater technological weight, also does not help in terms of the sector divergence (growth vs. value) that we have seen lately and that could last for at least some quarters. As a result, we expect the losses of the main MSCI EM to stabilize at the -10% level for the end of this year (total return), and very timid positive returns in 2023. The correction in 2022 for the adverse scenario would be close to -30%, particularly bad if we take into account that during 2021 there was already a significant underperformance vis-a-vis the US.

Figure 34: USD-denominated debt: maturity vs. relative size



Sources: Refinitiv, IIF, Allianz Research

Figure 35: Capital market forecasts

year-end figures	Last value	Unit		Baseline		Adverse	
EMU			**2021**	**2022f**	**2023f**	**2022f**	**2023f**
Government Debt							
Policy rate (ECB deposit rate)	-0.50	%	-0.50	0.75	1.25	1.25	0.00
10y yield (Bunds)	1.76	%	-0.18	1.50	1.20	1.90	0.30
10y EUR swap rate	2.42	%	0.28	1.80	1.50	1.80	0.70
Italy 10y sovereign spread	203	bps	136	220	200	230	180
France 10y sovereign spread	56	bps	37	60	50	65	45
Spain 10y sovereign spread	109	bps	77	120	100	130	85
Corporate Debt							
Investment grade credit spreads	188	bps	98	170	140	280	160
High-yield credit spreads	537	bps	331	525	425	750	550
Equity							
Eurostoxx (total return p.a.)	-16.6 ytd	%	20.4	-9	5	-23	10
US			**2021**	**2022f**	**2023f**	**2022f**	**2023f**
Government Debt							
Policy rate (upper)	1.50	%	0.25	3.50	3.00	4.00	1.00
10y yield (Treasuries)	3.31	%	1.50	3.20	2.90	1.20	1.50
Corporate Debt							
Investment grade credit spreads	149	bps	98	160	130	300	170
High-yield credit spreads	505	bps	310	500	400	850	650
Equity							
S&P 500 (total return p.a.)	-20.4 ytd	%	26.9	-15	7	-28	15
UK			**2021**	**2022f**	**2023f**	**2022f**	**2023f**
Government Debt							
Policy rate	1.25	%	0.25	2.00	2.00	3.00	0.50
10y yield sovereign	2.65	%	0.97	1.80	1.80	2.20	1.10
Corporate Debt							
Investment grade credit spreads	193	bps	115	190	150	290	160
High-yield credit spreads	607	bps	390	575	475	900	600
Equity							
FTSE 100 (total return p.a.)	-1.3 ytd	%	14.3	-5	4	-20	7
Emerging Markets			**2021**	**2022f**	**2023f**	**2022f**	**2023f**
Government Debt							
Hard currency spread (vs USD)	363	bps	295	370	340	650	600
Local currency yield	7.2	%	5.7	7.5	7.0	9.0	8.0
Equity							
MSCI EM: total return p.a. in USD	-16.5 ytd	%	-5	-10	4	-30	17

Source: Allianz Research

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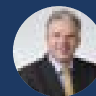

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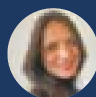

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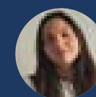

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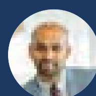

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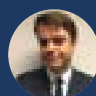

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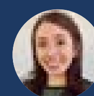

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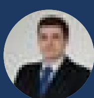

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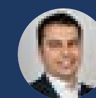

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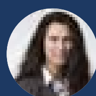

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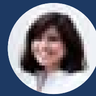

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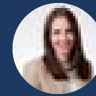

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