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Allianz Research

Lights out! Energy crisis, policy mistakes and uncertainty

Fall Economic Outlook

Executive Summary

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- As Russian gas supply is coming to a halt, the fight against inflation is raging and political uncertainties coalesce, our previous adverse scenario has become reality. The trifecta of lower growth, higher inflation and higher rates will hit even harder. We expect global growth to slip into negative territory in Q4 (-0.1% q/q), followed by a slow recovery at +1.5% in 2023. Consumer sentiment has already plunged to record lows and business confidence continues to deteriorate rapidly, which will hold back consumption and investment.

- Eurozone growth is likely to plunge to -0.8% in 2023 due to soaring energy prices and negative confidence effects. Increased fiscal support to the tune of 2.5% of GDP on average and limited monetary easing after mid-2023 will help make the recession shorter and shallower, and limit the risks of social unrest. But it will not fully offset the shock on real disposable incomes and corporate margins.

- The US will register a -0.7% fall in GDP, mainly due to rapidly tightening monetary and financial conditions, which will significantly cool the housing market, coupled with a negative external environment and low fiscal support after the mid-term elections.

- Inflation will remain high until Q1 2023 after energy prices have peaked, with food and services adding upside pressure. We expect global inflation to average 5.3% in 2023 (after close to 8% in 2022). Eurozone inflation should peak at 10% in Q4 2022 and then average 5.6% in 2023. In the US, inflation is likely to have peaked already but should remain above 4% until Q1 2023, falling below 2% only after Q3 2023 (averaging 2.9% in 2023).

- Central banks' determination to fight inflation could lead short-term sovereign rates to go above neutral terminal rates in both the US and the Eurozone (to 4% and 2.25%, respectively). Both the Fed and the ECB will remain hawkish compared to other recession episodes, with limited rate cuts after mid-2023. We expect persistent yield-curve flattening until year-end, with recession concerns keeping long-term rates anchored at 3.25% in the US and 1.6% for the 10Y German Bund.

- Several emerging market (EM) countries are at risk of balance-of-payments crises (Argentina, Chile, Colombia, Egypt, Hungary, Kenya, Pakistan, Poland, Romania, and Turkey). While EM sovereign risk is already reaching dangerous levels, there is room for a further increase in yields and spreads. Even if the global economy avoids a deeper recession, we do not expect conditions in the EMs to improve until late next year.

- The outlook significantly depends on the impact of financial tightening across major economies and the effectiveness of fiscal support. We see further downside risk to equity valuations before markets recover next year, with single-digit returns.

- Corporate risk has risen again, but higher fiscal support should prevent a large wave of business insolvencies and an acceleration in severity rates. Nonetheless, for the Eurozone overall, we expect insolvencies to increase by more than +40%. Corporate credit spreads should experience a contained widening but some spread compression next year. Deeply negative real rates facilitate higher deficit spending to cushion the impact of the cost-of-living crisis on consumers and firms. However, they also leave countries with higher debt levels at a time when interest rates are rising, which increases the pressure for a potentially painful fiscal adjustment at the end of next year.

- Key political events will bring further volatility and higher geopolitical tensions – notably the increased US-China rivalry and Europe's response to the energy crisis – will provide additional tailwind fuel to current decoupling tendencies.

+1.5%

Global GDP growth in 2023

Macroeconomic and Corporate Outlook

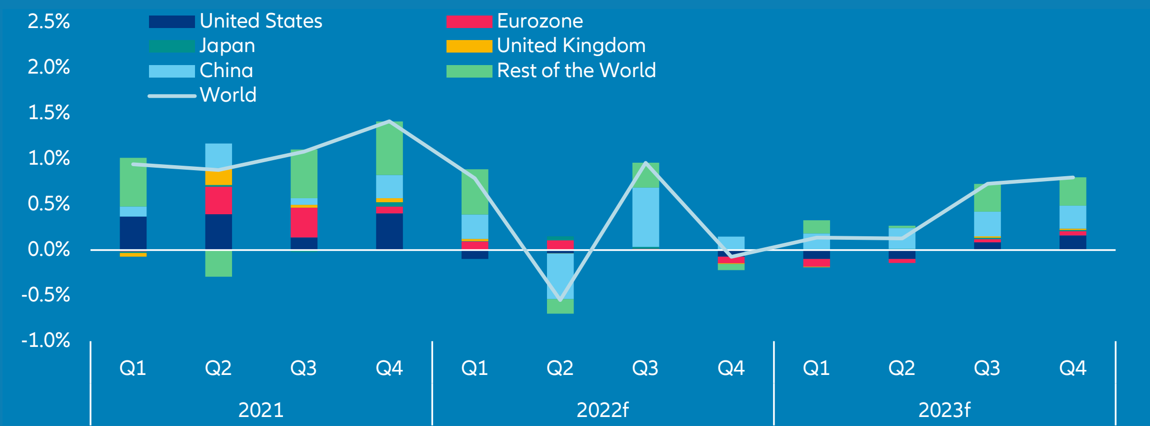
In 2023, the energy crisis and rising interest rates will drag global GDP growth down to just +1.5%, as slow as it was in 2008. Since June, global macroeconomic conditions have considerably worsened, moving into our adverse "black-out" scenario to which we originally assigned a 40% probability since the start of the war. Deep and long-lasting ruptures in energy markets and the negative impact on business confidence will push the manufacturing sector in most countries into recession. At the same time, rapidly rising interest rates and falling real disposable incomes will induce a housing recession in the US. After contracting by -0.6% in the second quarter of 2022, global growth will return to negative territory in Q4 (-0.1% q/q) and is not likely to recover before mid-2023. Overall, we have cut our 2023 forecast to +1.5% (-1.0pp compared to our Q2 forecasts). Global trade growth in volume will also remain low at +1.2% in 2023 as advanced economies face a domestic demand-led recession.

Table 1: Annual GDP growth forecasts, %

Growth (quarterly q/q% & yearly y/y%)	2020	2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	2022	Q1 2023	Q2 2023	Q3 2023	Q4 2023	2023
Global	**-3.4**	**5.6**	**0.8**	**-0.6**	**1.0**	**-0.1**	**2.7**	**0.1**	**0.1**	**1.0**	**1.1**	**1.5**
USA	**-3.4**	**5.7**	**-0.4**	**-0.2**	**0.5**	**-0.3**	**1.4**	**-0.4**	**-0.4**	**0.3**	**0.6**	**-0.7**
Latin America	**-6.9**	**6.3**	**1.0**	**0.7**	**-0.2**	**-0.4**	**3.0**	**0.1**	**0.5**	**0.6**	**0.6**	**1.5**
Brazil	-4.2	5.0	1.0	0.5	0.4	0.0	2.8	-0.1	-0.1	0.3	0.6	0.7
UK	**-9.3**	**7.4**	**0.8**	**-0.1**	**0.1**	**-0.3**	**3.4**	**-0.2**	**0.0**	**0.4**	**0.4**	**-0.2**
Eurozone	**-6.5**	**5.3**	**0.5**	**0.7**	**0.1**	**-0.5**	**3.1**	**-0.6**	**-0.3**	**0.2**	**0.3**	**-0.8**
Germany	-4.1	2.6	0.8	-0.0	0.1	-0.6	1.6	-0.8	-0.3	0.1	0.2	-1.3
France	-7.9	6.8	-0.2	0.5	0.4	-0.3	2.5	-0.6	-0.3	0.4	0.4	-0.6
Italy	-9.1	6.6	0.1	1.1	1.1	-0.4	3.4	-0.5	-0.2	0.2	0.2	-0.5
Spain	-10.8	5.1	0.2	1.1	0.3	-0.7	4.3	-0.5	-0.2	0.5	0.7	-0.3
Emerging Europe	**-2.4**	**6.2**	**0.9**	**-1.8**	**-1.5**	**-0.8**	**-0.8**	**-0.7**	**1.3**	**1.1**	**7.0**	**-1.0**
Russia	-3.0	4.7	-0.3	-6.0	-4.5	-1.5	-5.4	-1.0	1.5	1.5	0.3	-4.1
Turkey	1.8	11.0	0.7	2.1	2.0	-0.5	5.8	-1.0	2.0	1.0	1.0	1.9
Poland	-2.1	5.9	2.5	-2.1	0.0	-0.3	4.0	-0.5	2.0	1.0	1.0	1.0
Asia-Pacific	**-0.9**	**6.1**	**0.7**	**-0.5**	**2.0**	**1.6**	**3.4**	**0.9**	**0.7**	**0.9**	**1.1**	**3.9**
China	2.2	8.1	1.4	-2.6	3.4	0.8	2.9	0.9	1.2	1.4	1.3	4.5
Japan	-4.7	1.7	0.1	0.9	0.4	0.1	1.5	0.2	0.3	0.3	0.3	1.1
Middle East	**-4.2**	**3.8**	**1.5**	**0.7**	**1.0**	**0.7**	**6.2**	**1.2**	**0.7**	**0.9**	**0.8**	**3.5**
Saudi Arabia	-4.1	2.9	2.6	0.4	0.6	1.0	9.2	0.9	0.9	0.9	0.9	4.2
Africa	**-2.5**	**3.3**	**0.3**	**-0.3**	**0.7**	**1.0**	**3.2**	**1.1**	**1.1**	**1.0**	**0.9**	**3.1**
South Africa	-6.3	4.9	1.9	-0.7	0.0	0.4	1.8	0.5	0.5	0.4	0.4	1.5

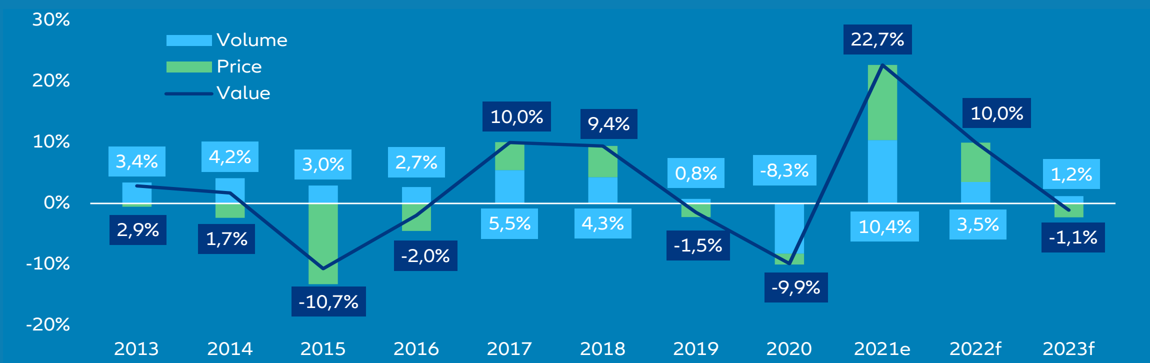
Sources: Refinitv Datastream, Allianz Research

Figure 1: Quarterly GDP growth forecasts, %



Sources: National authorities, Refinitv Datastream, Allianz Research

Figure 2: Global trade forecasts, %



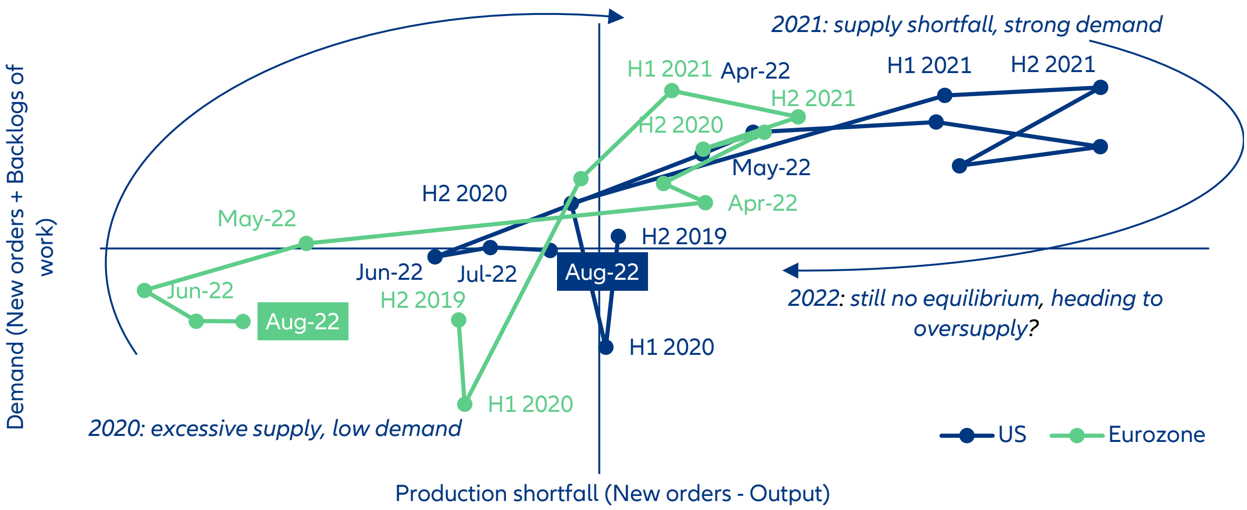
Sources: National authorities, Refinitv Datastream, Allianz Research

Inflation is still snowballing. Despite the global recession in Q4, we expect price pressures to remain high until Q1 2023 when gas prices are expected to peak. Food and services prices will also drive up inflation until year-end. OveInflation is still snowballing. Despite the global recession in Q4, we expect price pressures to remain high until Q1 2023 when gas prices are expected to peak. Food and services prices will also drive up inflation until year-end. Overall, we expect global inflation to reach 5.3% in 2023 (after close to 8% in 2022).

In the US, inflation peaked in June at +9.1% y/y and has started to come down since then. Prices were flat over the month in July, the lowest reading since November 2020. However, lower price pressures are for now entirely energy-related; core and food inflation are not showing any signs of cooling yet. Inflation is expected to keep coming down rapidly over the next 12 months or so to around 1.5% y/y in Q4 2023. First, energy inflation should continue to ease off as the global economic slowdown bears down on oil prices. The rapidly weakening global growth environment is also pushing down metal prices, which will ultimately ease the price pressure on core goods. US manufacturers are already reporting sharply lower input costs. The strong USD is also pushing down import prices (for goods and commodities). Second, global supply-chain disruptions are showing signs of easing – partly the result of softer demand. Durable goods inflation has come down over the past three months and should continue to decline in the months ahead as supply chains continue to normalize. Third, news on food prices continues to brighten. The avian flu outbreak in the spring triggered a massive surge in chicken and egg prices, but that run up is now being reversed. The decline in agricultural commodity prices should also start to weigh on processed food inflation in the months ahead. Production price pressures in the food industry have already started to cool off. Finally, while core services inflation should remain high for longer, a Fed-induced squeeze in demand will eventually push down services inflation from early 2023 onwards. All in all, inflation should still remain above 4% until March 2023 and fall below 2% only after September 2023, reaching 2.9% over the full year after +7.8% in 2022.

In the Eurozone, the peak could hit close to 10% in Q4 2022 and remain above 4% until Q4 2023 (5.6% on average over the year). However, there are increasing signs that global supply-chain bottlenecks as well as corporate price expectations have peaked as demand is rapidly weakening. As a result, the inventory glut in the manufacturing and construction sectors could help bring down inflation in 2023. Overall, close to 90% of inflation in the eurozone is explained by supply chain bottlenecks and energy prices against 75% in the US. The risk of a wage-price loop is likely to be contained, but upside risks prevail. We expect wage growth at +4.1% in the US in 2023, +3.4% in the Eurozone and +4.8% in the UK, with unemployment rates starting to rise (to 4.5%, 7.2% and 4.0%, respectively).

Figure 3: Supply vs. Demand



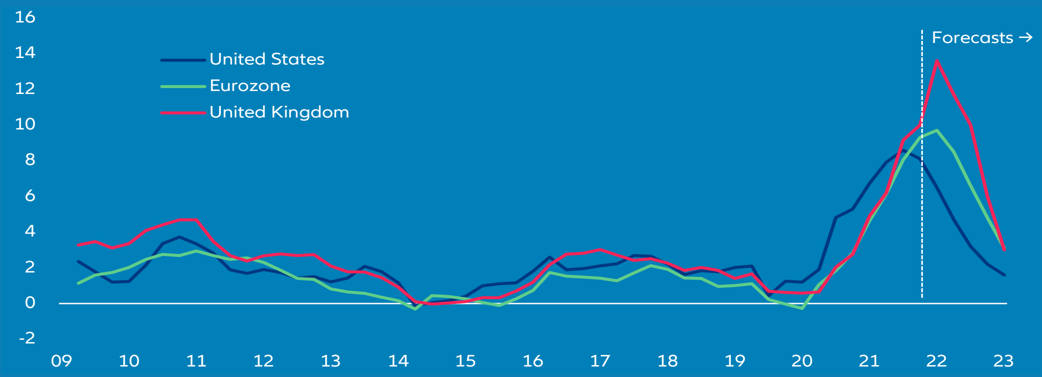
Sources: Markit , Allianz Research

Figure 4: Oil and gas price forecasts

	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
Oil Brent (USD per barrel)	97	95	90	90	85	80
Natural Gas (Dutch TTF) (€/Mwh)	200	230	250	220	200	210

Sources: Refinitv, Allianz Research

Figure 5: Quarterly inflation forecasts for Eurozone, US, UK, %



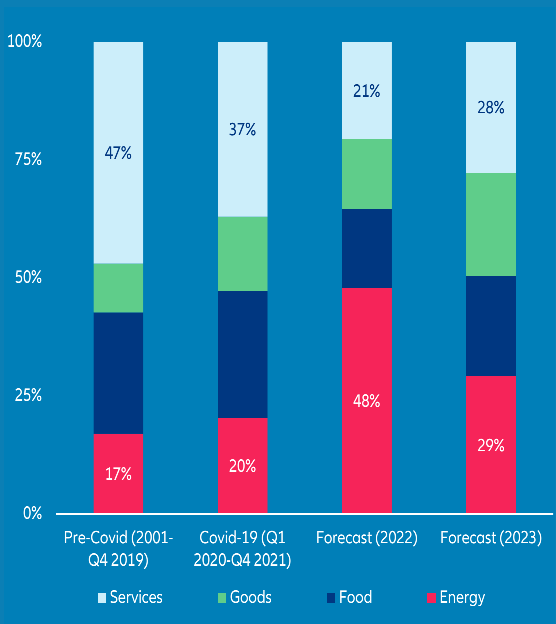
Sources: Markit PMIs, Refinitv Datastream, Allianz Research

Table 2: Annual inflation forecasts, %

Inflation (yearly %y/y)	2020	2021	2022f	2023f
Global	**2.7**	**4.2**	**7.9**	**5.3**
USA	**1.3**	**4.7**	**7.8**	**2.9**
Latin America	**11.8**	**13.9**	**17.6**	**13.4**
Brazil	3.2	8.3	9.8	5.7
UK	**0.9**	**2.6**	**9.8**	**7.5**
Eurozone	**0.3**	**2.6**	**8.3**	**5.6**
Germany	0.5	3.1	8.5	6.2
France	0.5	1.6	5.5	4.3
Italy	-0.1	1.9	7.2	5.2
Spain	-0.3	3.1	9.0	5.7
Emerging Europe	**4.5**	**8.1**	**23.7**	**14.0**
Russia	3.4	6.7	14.5	12.0
Turkey	12.3	19.6	71.2	30.8
Poland	3.4	5.2	14.0	10.9
Asia-Pacific	**2.2**	**1.6**	**3.5**	**2.9**
China	2.5	0.9	2.1	2.2
Japan	-0.0	-0.2	2.3	1.6
India	6.6	5.1	7.0	5.7
Middle East	**9.9**	**15.8**	**20.5**	**19.0**
Saudi Arabia	3.5	3.1	2.4	2.5
Africa	**10.0**	**12.4**	**14.7**	**9.6**
South Africa	3.3	4.6	6.8	5.0

Sources: Refinitv Datastream, Allianz Research

Figure 6: Eurozone-Inflation decomposition (contribution to annual changes in CPI, %)

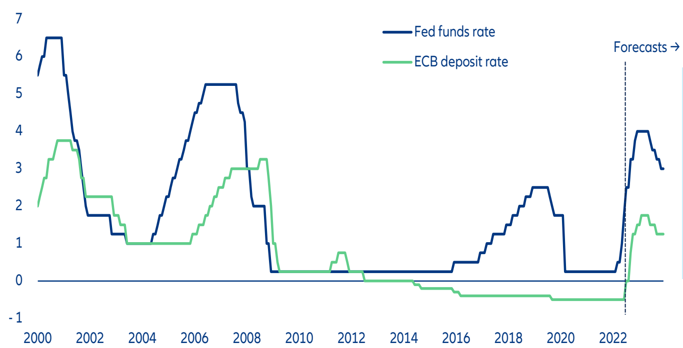


Sources: Refinitv Datastream, Allianz Research

We expect further monetary tightening before major central banks switch to aggregate demand support with several (limited) policy rate cuts after mid-2023. Even if the looming recession drives the unemployment rate up and core inflation continues to soften, we expect central banks to resist easing their monetary stance too soon. In the US, the policy rate should peak at 4% by December 2022 and remain there through H1 2023 despite the economy slipping into a recession and a precipitous decline in headline inflation. The FOMC will want to see clear evidence that inflation is durably around target and be wary of easing policy too much. The Fed is also expected to continue shrinking its balance sheet through at least Q1 2023. We are penciling in a cumulative 100bps rate cut from the summer onwards, with rates bottoming out at 3%, in line with the neutral rate. This is in stark contrast to previous recession-induced easing cycles since the early 1990s, when the Fed was much more aggressive in responding to economic downturns. Similarly, as long as inflation continues its upward trend, the ECB will remain on high alert. Its latest and largest ever rate hike of 75bps clearly signaled its commitment to fighting inflation. We forecast the ECB to raise interest rates at every single policy meeting until February 2023 (with the Main Refinancing Operations rate peaking at 2.25%). In the second half of 2023, we expect the ECB to opt for a "policy pivot light" by reducing the policy rate by -50bps to 1.75% (close to the ECB's estimate of the neutral rate). Quantitative tightening will have to be managed with extra caution.

Inflation in emerging markets (EMs) is now expected to peak only in early 2023 so most central banks will continue to hike interest rates. However, in some countries, "hiking fatigue" has set in since the direct effect of additional rate hikes on inflation appears limited in the context of the global energy shock. Some central banks might refrain from aggressive hiking if the risk of social discontent is high. There are also regional differences: The largest interest rate increases are expected in Emerging Europe, where the most negative real policy rates prevail even as inflation has surged to double digits, followed by Latin America (where central banks have been more aggressive to date) and Africa (where interest rates were generally higher prior to the energy crisis). Most of Emerging Asia started their rate-hiking cycles later in 2022. More hikes are likely, given the above-target inflation rates, though these are mostly still in the single digits. Monetary policy in the Middle East mostly follows the Fed owing to prevailing currency pegs. Starting in mid-2023, EMs are expected to begin with gradual monetary easing. Countries in the Middle East and Asia will be the first in line, followed by Latin American ones. Central banks in Emerging Europe and Africa, where inflation is forecast to be more persistent, will lag behind.

Figure 7: Key interest rates, %



Sources: Refinitiv Datastream, Allianz Research

Table 3: Wage growth and unemployment rate, %

	Wage growth (%)			Unemployment rate (%)		
	2021	2022f	2023f	2021	2022f	2023f
United States	4.2	5.2	4.1	5.4	3.7	4.5
United Kingdom	5.9	5.0	4.8	4.5	3.8	4.0
Germany	3.1	3.4	3.2	5.7	5.3	5.7
France	1.5	3.4	4.1	7.9	7.4	8.1
Italy	2.0	3.0	2.7	9.5	8.2	8.6
Spain	1.3	3.0	3.5	14.8	14.1	14.5

Sources: Refinitiv Datastream, Allianz Research

The Eurozone will slip into recession next year (with GDP contracting by -0.8%) due to soaring energy prices and negative confidence effects. Structural headwinds continue to mount, especially on the back of higher energy prices. The risk of forced rationing in the winter of 2022-23 has declined to a relatively low level, largely thanks to gas storage facilities filling to above 80% faster than expected. However, it cannot be fully ruled out, given remaining uncertainties such as how cold this winter will be, and how willing households and firms are to reduce their demand for gas (see Box "**European Energy Crisis-Adverse Scenario**")[1]. But even without forced rationing, sobriety measures will be needed and the economy will eventually slip into recession at the turn of 2022-23, with an anemic recovery to unfold only in the second half of 2023. After all, energy-intensive industries have already started to cut their energy consumption amid sky-high prices, and the extent to which this will worsen and result in larger production stops will depend on how wide the price cap measures get in Europe. We expect corporate margins to drop by -2pp in 2023, the equivalent of a EUR150bn loss of EBITDA margin. Metals, papers and pulp, chemicals, food and beverages and textiles are likely to be the most exposed.

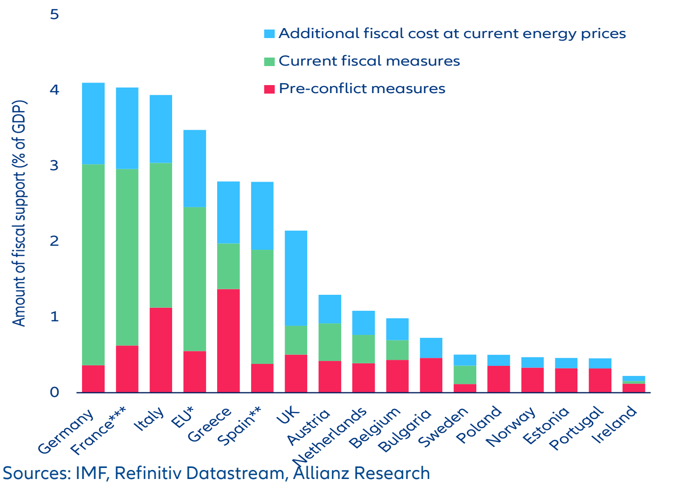
To add to this, as inflation remains elevated (far exceeding wage growth of +3.2% and +3.4% in 2022 and 2023, respectively), and unemployment rises from record lows, household consumption is heading for a sharp contraction at the turn of 2022-23. While government support has ramped up to about 2.5% of GDP on average, it will not fully offset the shock on real disposable incomes.

In light of cooling global demand and prolonged supply bottlenecks, net exports will not save the day despite a weak euro over the forecast horizon. We expect near parity with the US dollar until end-2022 due to a very hawkish Fed providing fundamental support to the USD and concerns about Eurozone economic growth. For 2023, we expect EURUSD to reach 1.10 in Q4, below the level before the start of the Russia-Ukraine conflict (above 1.15). This reflects a very slow recovery from the energy crisis as well as a moderately narrowing interest rate differential.

We expect Eurozone GDP to contract by -0.8% in 2023 after an expansion of +3.1% in 2022. This would mean a total output loss of more than -2pp. And the medium-term economic prospects are not much brighter. Structural headwinds including higher energy prices and limited gas supply, along with persistent geopolitical uncertainty and constrained policy room for maneuver, will weigh on the growth outlook and the risk of a prolonged recession into 2024 is increasing. The export-based industrial heavyweight Germany is among the most exposed and will face the most challenging economic context since its reunification.

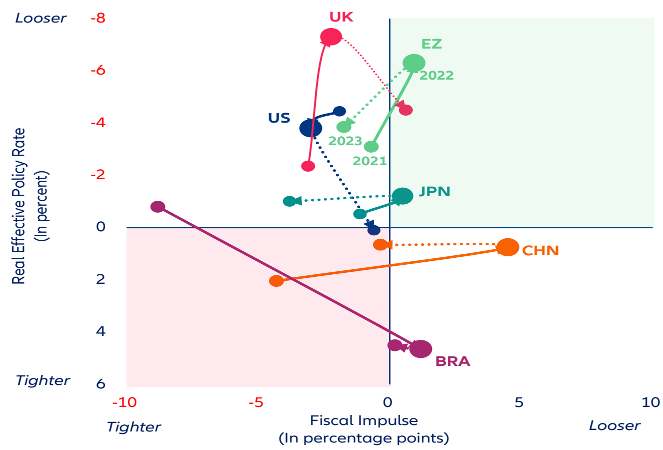
For 2023, we have penciled in a sizeable fiscal support package in Europe as monetary policy is passing the baton. In the first half of 2022, Europe has already spent close to half a trillion to offset the cost of the energy crisis on households' disposable income. The electricity market reform, the pursuit of more targeted aid measures, as well as an overhaul of fiscal rules to finance the green transition, are all in the cards. Increased fiscal support to the tune of 2.5% of GDP on average - and limited monetary easing after mid-2023 - will help make the recession shorter and shallower and limit the risks of social unrest. However, it will not fully offset the shock on real disposable incomes and corporate margins.

Figure 8 a: Europe fiscal support measures



Sources: IMF, Refinitiv Datastream, Allianz Research

Figure 8 b: Largest economies : fiscal and monetary stance



Sources: IMF, Refinitiv Datastream, Allianz Research

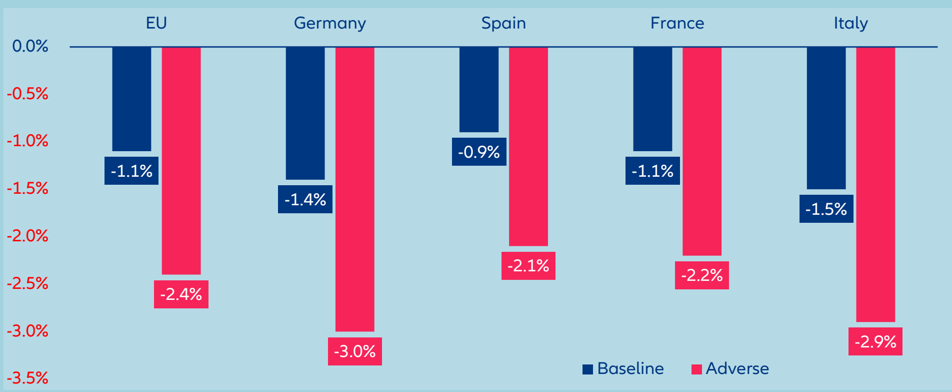
[1]As the most exposed economies (Germany and Italy) look set to enter the heating period with storage levels well above 80% of total capacity, the risk of a gas shortage has decreased notably. However, the most decisive factor will be the extent to which the private sector can cut back on gas consumption.

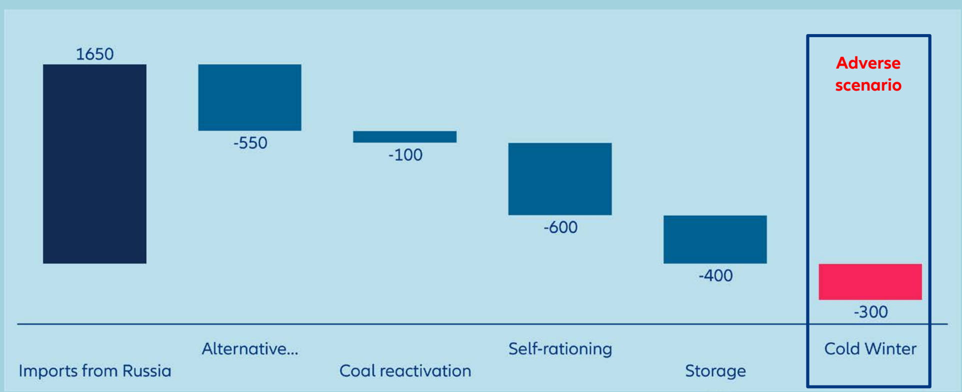
Box: European Energy Crisis-Adverse Scenario

As of early September, the European economy will have to learn to run without Russian gas after the Nord Stream 1 to Germany was shut off indefinitely. Alternative sources, including LNG from the US, Australia and Qatar and the reactivation of coal and nuclear power plants, as well as tapping storage facilities will help reduce the Russia gas gap. However, the private sector will still need to cut its gas consumption by at least 15%. High energy prices and government schemes that compensate firms for cutting back on their gas usage and/or switching to other energy sources should lead to the necessary self-rationing.

In our adverse scenario, private sector gas demand is only reduced by 5% as policy support measures drown out price signals, and in turn saving incentives and severe winter weather make it impossible to reduce the amount of gas used for heating. To close the gas supply gap of 10% would call for forced rationing, which would trigger a sharp recession, with a total GDP loss to the tune of 2.4% in 2024, the double of the baseline scenario. Germany and Italy would be the most exposed among the large economies, given their greater reliance on (Russian) gas. Mitigating fiscal policy action could help reduce the economic pain. In such an adverse scenario, we believe the ECB will have revert to limit financial stress in the Eurozone.

Figure 9 a,b: GDP at risk and gas gap (baseline and adverse scenarios)





Sources: Refinitiv Datastream, Allianz Research

The US is also expected to slip into a recession in 2023 (with GDP down -0.7%), induced by rapidly tightening monetary and financial conditions. The housing market has already contracted, triggered by rising mortgage payments, lower housing affordability and tighter bank credit conditions. From a historical perspective, the pass-through of Fed rate hikes to mortgage interest rates is stronger than during any previous Fed tightening cycles since the mid-1980s. Forward-looking monetary indicators point to an imminent drop-back in property prices, which has historically dampened GDP significantly through negative wealth effects and an adverse effect on household confidence. There is also rapidly faltering momentum in the manufacturing sector, hit by the stronger dollar, a pullback in consumer demand for goods and elevated inflation dampening household income. The latter is well below its implied pre-pandemic trend. On the corporate side, higher interest rates are gradually feeding in through higher debt-service expenses. Corporates are generally cutting back investment plans.

-0.7%

US GDP growth in 2023

We expect US GDP to contract by -0.7%, with a cumulative GDP loss of -1.2pp. This is a sizeable contraction but milder than the average US recession. First, private sector balance sheets look strong in aggregate, which should limit the extent of spending cutback, particularly for households. Second, the US economy is much more immune to the current energy shock compared to the past (e.g. during the 1970s) since it is now a net energy exporter. Against this backdrop, the mid-term elections, political division and inflation-adverse policymakers mean that we expect fiscal policy to remain restrictive next year despite the recession, though at a much more moderate scale than in 2022. The recently enacted fiscal bill – a watered down version of the Build Back Better Framework – constitutes a net fiscal tightening, with upcoming tax hikes (USD700bn) more than offsetting new spending (USD400bn). It will be spread over several years, with little effect on growth and public finances in the short term. The general government fiscal deficit is projected to widen to –5.4% of GDP, from –3.7% in 2022, on the back of recession-induced weaker revenues and higher spending.

After a very low level of growth in 2022, China's economic recovery will be difficult. We have significantly cut our growth forecasts to +2.9% in 2022 (from +4.1%) and +4.5% in 2023 (from +5.2%) based on four factors: the short-lived post-omicron reopening boost, the likely continuation of the zero-Covid policy until Q2 2023, which is weighing on business and household confidence, risks in the property sector and extreme weather currently pressuring energy supply. In addition, lower external demand will limit export growth, which had been a tailwind throughout 2020-2021. Fiscal support was ramped up over the past few months, with spending increasing from 3.0% of GDP to 4.5% (implying an impulse roughly half of that in 2020). The central bank cut rates in August 2022, against expectations and sending the signal that monetary policy will remain accommodative. That said, we expect just one more policy rate cut in the coming quarters and the People's Bank of China is likely to favor other less high-profile tools to support the economy as the Fed tightening prompts a depreciation of the RMB vs. the USD. The overall supportive policy mix provides a buffer to the economy to avoid crises but is unlikely to engineer a strong rebound. The key is to restore business and household confidence, which could be helped by a potential easing of the zero-Covid policy from Q2 2023 after important political events are out of the way.

Emerging markets (EMs) are increasingly embattled. We have cut our growth forecasts for EMs in 2022 and especially in 2023. Persistently high inflation and rising interest rates will affect consumer spending and investment while the weakening global economy reduces external demand.

• **Emerging Europe**: Most economies will experience a recession in 2022-2023, notably the export-dependent economies of Czechia, Slovakia and Bulgaria, as well as the highly energy import-reliant Baltic states.

•**Latin America**: The region has surprised positively in 2022 in light of resilient economic activity in the first half, especially in Brazil, Mexico and Colombia, thanks to gains in terms of trade, additional fiscal stimulus and a firm labor market. We have revised our growth projections upward from +2% to +2.8% this year, especially driven by Brazil's strong performance. However, we expect economic growth to moderate due to persistently high inflation, stronger monetary tightening and lower global growth prospects. In addition, political uncertainty has increased ahead of key elections (e.g. Brazil) and/or continued instability (e.g. Peru).

• **Emerging Asia**: We have also cut growth forecasts for Emerging Asia (excluding China). South and Southeast Asian countries have benefited from a larger post-Covid catch-up effect in 2022 and Q2 performance has been strong. The better growth-inflation trade-off allowed their central banks to start the rate-hiking cycle later (e.g. India, Malaysia and the Philippines in May; Indonesia and Thailand in August). On the other hand, the quasi-developed and export-oriented economies of Hong Kong, Singapore, South Korea and Taiwan started monetary tightening earlier (e.g. in August 2021 in South Korea) and will see growth slowing due to a deteriorating external demand environment. Going into 2023, Emerging Asia will see slowing economic momentum but avoid a recession.

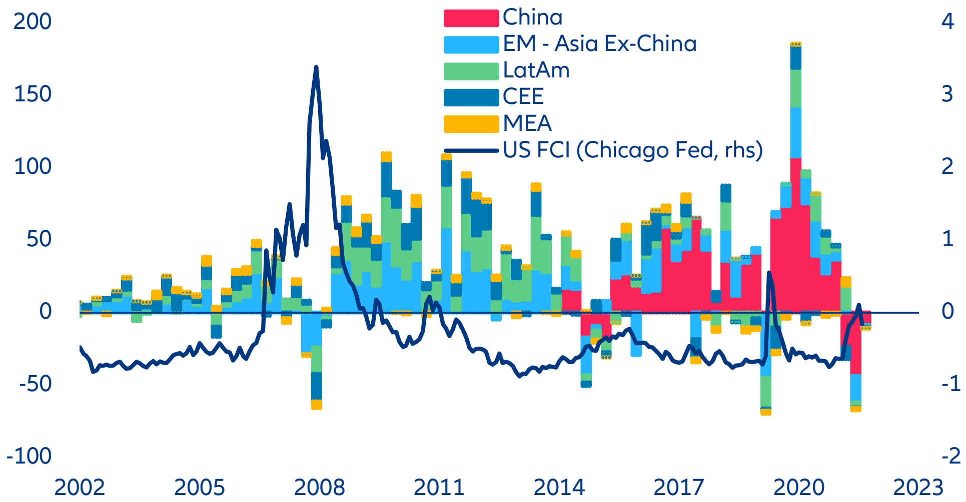
• **Middle East**: The region will experience a marked acceleration of growth from a sluggish 2021, thanks to high energy prices and rising hydrocarbon production.

Several EMs are at risk of balance-of-payments crises. The current account balances will deteriorate in all EMs (except for energy exporters) due to rising import bills, weaker global demand and the problems in China (zero-Covid policy, real estate crisis, geopolitical disputes). Relief will not come from the financial account: negative investor sentiment and increasing interest rates in advanced economies are prompting a flight to safety that translates into capital outflows and a strong US dollar. Most EM currencies have depreciated against the strong USD in 2022 but only a few have fared worse than the EUR: Argentina, Turkey, Ukraine and Venezuela (all idiosyncratic cases); Egypt, Ghana, Hungary and Pakistan (which has particularly large external imbalances); Poland as well as a number of smaller developing economies.

Emerging market sovereign risk is reaching alarming levels. Rising public debt levels have increased sovereign risk, sometimes aggravated by a depreciating currency that amplifies foreign exchange-denominated debt in relation to GDP. Belarus , Lebanon, Sri Lanka, Suriname, Russia, and Zambia are already in default. We do not expect a default wave among large EMs over the next year because a greater share of debt is issued in local currency and on domestic markets than in the 1980s and 1990s, although Argentina, Egypt, Pakistan and Turkey are still at risk. However, for DEs, a wave of defaults cannot be ruled out, with El Salvador, Ethiopia, Ghana, Kenya, Malawi, Mozambique andTunisia being most at risk. Moreover, given the fragile environment that EMs will continue to face in 2023, a deterioration from our baseline expectations increases the default risk of the four large EMs mentioned above and may enlarge the default wave for DEs, notably in Africa. In principle, the IMF stands ready as the last line of defense but difficult political situations can impede a timely loan agreement. Bilateral support is also likely for a number of countries: For example, the Fed may back Latin American countries in trouble as it did during the pandemic; the GCC may agree on further swap arrangements with Turkey and the EU or ECB are likely to assist EU members in CEE if needed. China could also use the circumstances to continue gaining financial influence by providing support, therefore boosting the international relevance of the RMB.

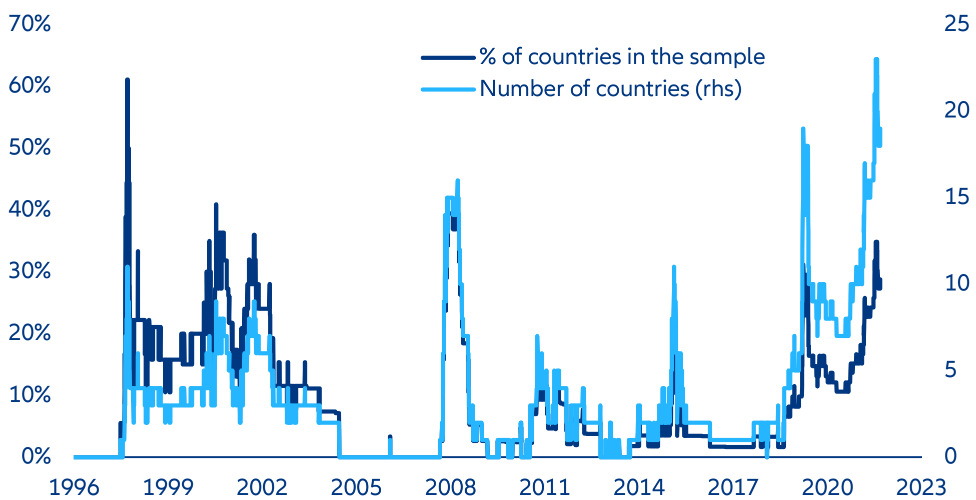
Against the backdrop of deteriorating macro-financial conditions, market pressures are slowly but steadily building. A few countries have defaulted or are on the cusp of doing so (Argentina, El Salvador, Sri Lanka, Tunisia, Venezuelac and Zambia). Sovereign yields in the local currencies of Brazil, Colombia, Ethiopia, Ghana, Kenya, Nigeria, Pakistan and Turkey are above 12% and not sustainable. Since Q2, foreign investors have pulled USD38bn out of EM stocks and bonds – the longest streak of net foreign portfolio outflows on record (Figure 12). Sovereign spreads have negatively reacted to the renewed hawkish stance of central banks in advanced economies (mainly the Fed). However, we do not expect a further deterioration through the end of the year, and things should look up again next year. While EM debt will be in dangerous territory well into 2023, we do not expect any major EM to experience debt distress. However, we expect a further spread-widening of USD-denominated sovereign debt, followed by marginal narrowing next year. In the case of EUR-denominated debt, the situation will not be better. The situation in the local currency debt space is hardly better. Our expectations for year-end are that yields will slightly increase to 7.3% (from 6.9% currently).

Figure 10: Emerging market net foreign portfolio flows (USD bn).



Sources: IIF, Refinitiv Datastream, Allianz Research Countries report data with different lags. Monthly data aggregated by quarters.

Figure 11: Share of emerging market sovereign spreads at distress levels



Sources: Bloomberg, JP Morgan, Allianz Research. Note: The sample is built from sovereign USD spreads of 66 countries as of September 2022, coming from a much smaller coverage in 1990s.

The outlook significantly depends on the impact of financial tightening across major economies. It will be tricky for central banks to navigate to an equilibrium where inflation falls but economic activity does not slip into a deep recession. In addition, the resilience of US households, which have become increasingly "financialized", will crucially influence how fast the US Fed will normalize its monetary stance and set the cadence of financial tightening globally. After all, rate hikes in the US affect not just real economic activity in the US, but also other advanced countries. While we expect inflationary pressures to abate towards the end of next year amid tighter financing conditions and declining demand, we see significant downside risks as central banks are likely to stay more restrictive for longer. Deeply negative real rates facilitate higher deficit spending to cushion the impact of the cost-of-living crisis on consumers and firms and mitigate the magnitude and duration of the recession. However, they also leave countries with higher debt levels at a time when interest rates are rising, which increases the pressure for a potentially painful fiscal adjustment, . Developments in China could significantly alter the macro-financial outlook. China's low tolerance for Covid-19 outbreaks and the weakness in its property sector pose risks to its growth outlook.

The return of credit risk is to be expected as this recession will be triaging the good, the bad and the ugly of corporate vulnerabilities. The rebound in business insolvencies gained momentum during 2022 (+18% q/q in Q2 2022, from +5% in Q1). The largest acceleration happened in Western Europe (+26% y/y YTD). Though we are still witnessing historically low numbers of bankruptcies in the US (-19% YTD as of Q2), China (-14% as of August) and Germany (-4% as of June), Spain, the UK and Switzerland already show pre-pandemic insolvency numbers. The trifecta of lower demand, prolonged production constraints (input prices, labor shortages and supply-chain matters) and increasing financing issues (access and costs) is mechanically pushing up expectations in business insolvencies, notably for European countries and sectors most exposed to energy issues. The -0.8% decline in Eurozone GDP has the potential to accelerate the rise in insolvencies by +25pp in 2023 (to more than +40%), with Germany up +16%, France up +29%, Italy up 31% and Spain up 25% (see Figure 13). This increases the probability of seeing the extension of and new (targeted) state aid measures.

Table 4: Business insolvencies, number and change

	Yearly change (%)				Number		Change ... (%)	
	2020	2021	2022	2023	2022	2023	2022 vs 2019	2023 vs 2019
United States	-5	-34	4	37	14,851	20,334	-35	-11
United Kingdom	-29	4	43	7	23,365	24,900	6	13
Germany	-16	-12	5	16	14,633	17,000	-22	-9
France	-38	-12	46	29	41,030	53,000	-20	3
Italy	-32	19	-2	31	8,338	10,950	-21	4
Spain	-5	30	12	25	5,750	7,200	38	73

Source: national

Key political events will bring further volatility with an attendant risk of worsening geopolitical tensions, adding to the current decoupling trend. In that context, reading the political tea leaves around the US mid-term elections as well as the Chinese leadership contest should provide insights into whether political leaders are ready to prioritize foreign policy matters that could amplify economic headwinds at home.

• Tensions in the Taiwan Strait and between the US and China are likely to remain topical in the coming months, with China's national holiday on 1 October, Taiwan's national holiday on 10 October, China's Party Congress starting on 16 October and the US mid-term elections on 8 November. Nancy Pelosi's official visit to Taiwan sparked increased military activity by China in the Taiwan Strait and economic measures (China against Taiwan, US against China etc.) have also been put in place in the past few months, with limited impact in the short-term. We continue to think that all parties will aim to avoid a military conflict in the coming years as the costs clearly continue to outweigh the potential benefits. Hurtful economic sanctions are also not in the central scenario as they would put another weight in the context of the upcoming recession in the US and the continued slowdown in China.

• In the US, a hung Congress, with a Democrat majority in the Senate and a Republican one in the Congress, is strengthening our scenario that not much is going to happen on the fiscal front – i.e. a continuation of fiscal consolidation but at a more moderate pace than in 2022. The infrastructure plan – dubbed the Inflation Reduction Act – is a watered-down version of Build Back Better. It has already been passed by the Congress and signed by the President. As a reminder, this scheme represents a (slight) net tightening of fiscal policy. Spending will be USD300 bn spread over several years – very short of a big infrastructure boost.

• The 20th National Congress of the Chinese Communist Party will start on 16 October and elect the country's leaders for the coming five years. Despite diverging signals arising from time to time in 2022, President Xi is likely to gain an unprecedented third mandate as the General Secretary of the Party. It will also be important to watch the composition of the new Politburo of the Central Committee (top 25 leaders of the country) and its Standing Committee (top seven leaders) to gauge the power of President Xi and political unity within the party. While factions are likely to remain, having this important political event out of the way could pave the way for increased policy coordination from 2023. Implementation of further policy support could thus improve, even though a significantly more dovish policy stance is unlikely (as leaders focus on long-term vulnerabilities and priorities).

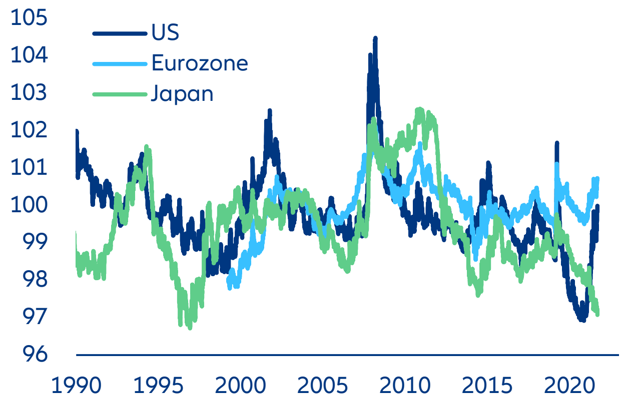
• It remains to be seen whether solidarity wins and Europe manages to once again emerge from this crisis on a stronger footing. The Italian snap election on 25 September – in which we expect Eurosceptic parties to emerge as frontrunners – should already provide an idea on whether the European electorate sees Europe as a solution or part of the problem of current economic woes, as well as whether the ECB's spread-fighting Transmission Protection Instrument is deemed credible by the market or not. Just like Europe delivered on fighting Covid19, the energy crisis is calling for unprecedented measures to reform the electricity market, guide in-country fiscal policy, and accelerate the energy supply pivot.

• In Latin America, the presidential elections in Brazil are looming and the political scene promises to be a turbulent one. Polls over recent months have systematically shown that former president Lula is ahead of current president Jair Bolsonaro (44% and 34% of voting intentions, respectively). Despite their political differences, both candidates have a loose approach to fiscal policy, which could deteriorate investor sentiment in a time of high interest rates, high debt and especially lower economic growth.

Capital Markets Outlook

Markets seem to be expecting a milder winter. Capital market conditions continue to deteriorate but still imply doubts about whether inflation-fighting central banks will really hike economies into a deep recession. Markets seem to expect a period of weak growth rather than an outright contraction (as projected in our baseline scenario above), which, in turn, could keep inflation higher and require more central bank hikes from currently still low levels.

Figure 14: Europe and US: Financial conditions index

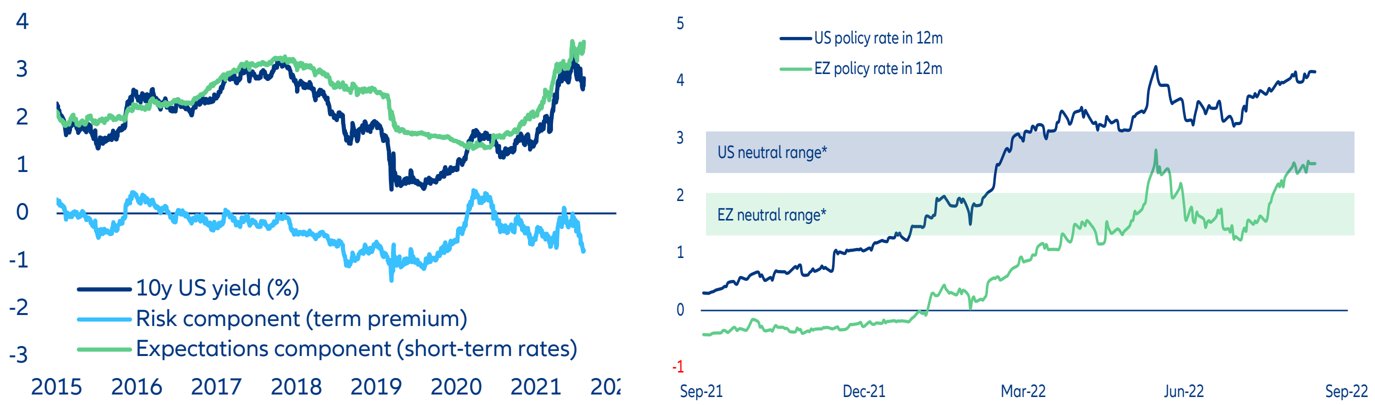


Sources: Goldman Sachs, Refinitv Datastream, Allianz Research

We see upside risks to short-term nominal rates over the near term before slowing inflation paves the way for a steepening of the yield curve towards the end of next year. While policy rates in the Eurozone (EZ) and the US remain above neutral over the next 12 months (signalling that monetary policy is already tight), expectations of some rate cuts later next year, especially in the US, would be consistent with a "softish landing"[2]. We expect the flattening (or inversion) pattern for the US and Eurozone yield curves to persist until the end of the year (US 10y: 3.25%; Bund 10y: 1.6%), with upside risks to short-term nominal rates. However, if our current baseline forecast of a significant, but not 2008-like, recession causes inflation to drop faster than markets expect, rate cuts early next year could pave the way for a shorter tightening cycle[3].

This would again steepen the US and Eurozone yield curves ("bull steepener") by 20-30bps, with the 10y UST reaching 2.9% (from 3.2% currently) and the 10y Bund 1.4% (from 1.6% currently). In contrast to the last 10 years, yield movements will be dominated by expected short-term rates, while the risk component (term premium) linked to the quantitative easing effect will take the back seat (Figure 15).

Figures 15 and 16: US and EZ term structure decomposition, policy rate expectations and neutral rate



Sources: Refinitiv Datastream, Allianz Research

[2] Short-term US yields have risen to the highest level since 2007 (3.4% for 2y UST), increasing the inversion between the 2y and 10y yields to -70bps (lowest level since 1989). Interest rate expectations explain most of the current changes in the yield curve, while term premia remained broadly unchanged.

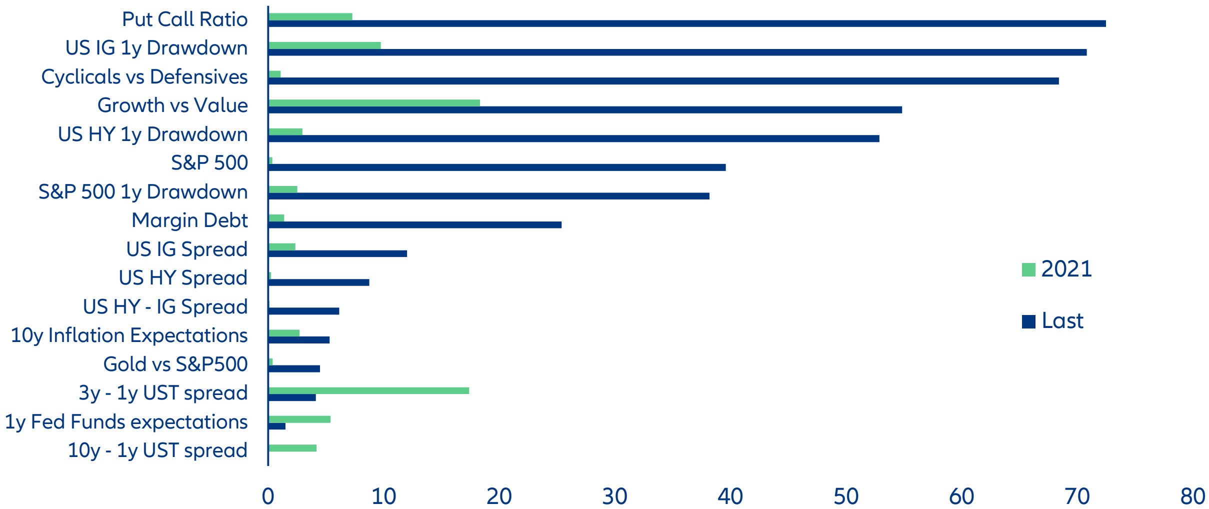
[3] For instance, in the US, the policy rate (2.5%) is already above the level (1.5%) implied by trend nominal growth (4.5%). Thus, reaching a 2% inflation target requires a decline of 1.5%-2.2% in GDP (leading to an unemployment rate of 5% to 6%) at a Fed Funds rate with a range of between 3.5% and 4.25% (which would be significantly above the neutral rate and current market expectations). Conversely, such a rise in the policy rate would not cause a recession if the nominal trend growth would be at least 1.5pp higher.

Having fallen -15-20% year to date, equity markets will remain under pressure until year-end, with mounting stagflationary concerns weighting on market sentiment. Market-implied recession probabilities range from 40 to 70% (Figure 17). Markets remain highly volatile and focused on near-term changes in macroeconomic conditions and policy expectations. Unlike in previous instances, the current risk-off sentiment is based on realized (rather than expected) data, which could prevent a structural positive trend reversal until central banks reach peak hawkishness (i.e. Q1 2023). Technology and growth-heavy markets continue to underperform due to their long-duration cash flow profiles. Regional differences have also become more pronounced: The Eurozone and emerging markets remain heavily shorted, with valuations having reached the cheap side. In the US, the current correction has brought valuations close to long-term averages.

We see upside potential for equities next year. Markets are likely to trade range bound until the end of 2022 (-15% EZ, -13% US and -17% EMs). Due to the short-lived nature of both the economic downturn and peak hawkishness, we do not expect the partially priced in structural erosion of companies' balance sheets to fully materialize. This should provide some tailwinds for 2023, leading global equity markets to recover. However, they will not return to pre-recession levels (+7% EZ, +8% US and +9% EMs).

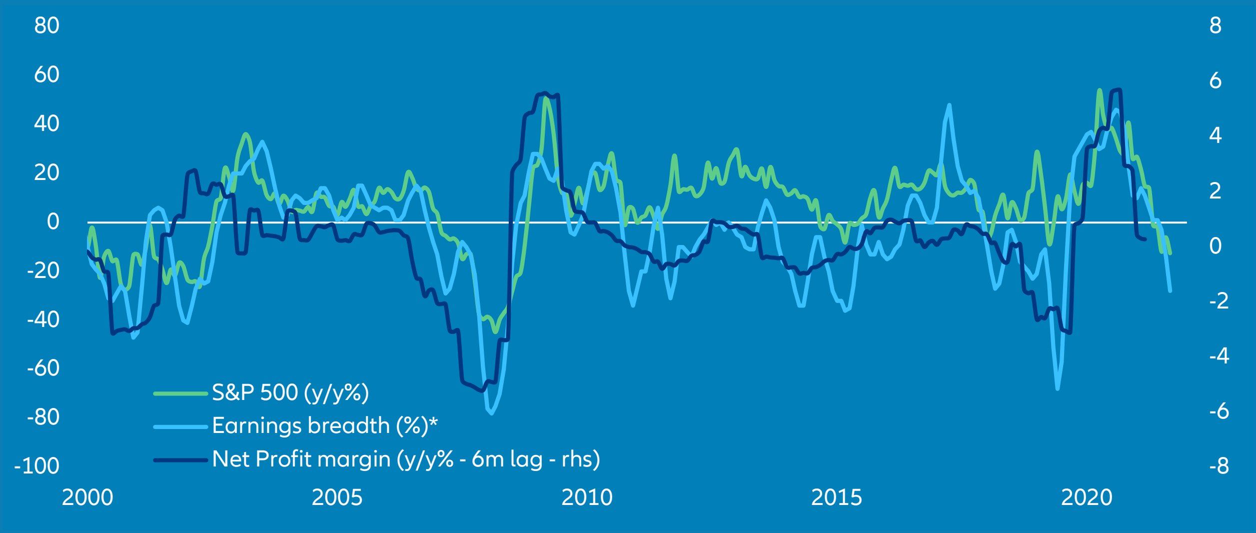
Higher financing costs and deteriorating business prospects could lead to a further widening of corporate credit spreads. Current risk repricing remains contained, with credit spreads below 2022. The sensitivity to policy rates and financing conditions is expected to remain elevated until Q1 2023, especially within lower rating buckets, which could cause short-lived spread-widening episodes. At the same time, increasing demand for the BBB and single-A brackets suggests a flight to quality. We expect a moderate increase in defaults in H1 2023, especially within the High Yield (HY) bucket, due to financing costs and slower earnings growth (i.e. slowing debt-servicing capacity). Issuance should also remain a challenge for High Yield corporates in 2022, as has been the case since February, but should accelerate in the second half of 2023. In the case of Investment Grade (IG), issuance should continue to slow down but remain relatively resilient both in 2022 and 2023. We expect IG credit to remain close to current levels (EZ: 200bps; US: 150bps) until the end of 2022 (EZ: 180bps; IG US: 150bps). In the case of HY credit, the asset class is expected to remain under pressure in 2022, keeping spread levels relatively elevated but close to current levels (EZ: 550bps; US: 475bps). Next year, the decline in financing costs followed by a pick-up in growth in the second half of 2023 should help corporate spreads to structurally compress at slightly higher than pre-recession levels (IG ~150bps and HY ~425bps).

Figure 17: US market-implied recession probabilities (%)



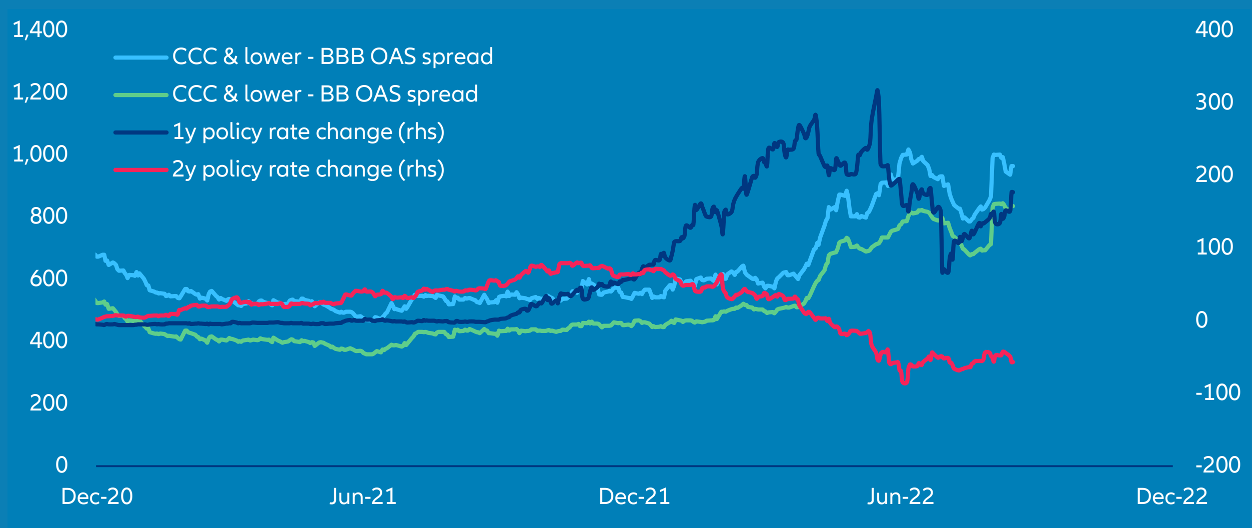
Sources: Refinitiv Datastream, Allianz Research

Figure 18: Corporate balance sheets expected to deteriorate



Sources: Refinitiv Datastream, Allianz Research
Note: * # of EPS upward revisions - # of EPS downward revisions as a % of total # of estimations

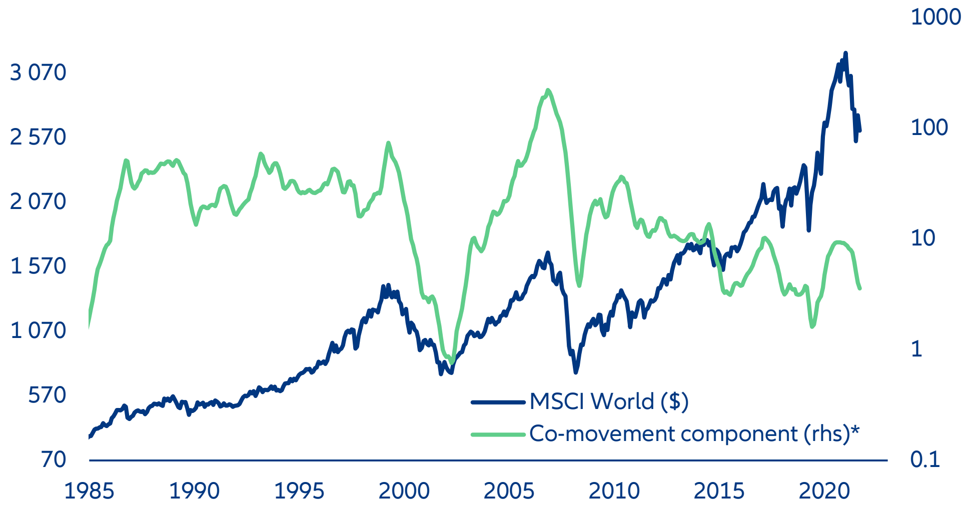
Figure 19: US corporate rating risk premium vs Fed Funds (bps)



Sources: Refinitiv Datastream, Allianz Research

We do not see the makings of a financial crisis (for now) but there are signs of stress in the market plumbing. While we continue to be in an unusual environment as both equities and bond markets have recorded heavy losses so far, this has not led to a structural rise in systemic risk. The higher-moment dependence across major markets and countries suggests that joint tail risk remains low (and nowhere near the levels seen during the major financial crises of the recent past). This could be explained by the still large amount of excess liquidity (and a gradual decline in money growth), which might have blunted the current impact of financial tightening. However, this dampening effect requires a smooth allocation of liquidity, especially via the repo market, which has been complicated by the high bond-market volatility. Thus, a systemic shock due to a market accident cannot be fully excluded as signs of stress persist (e.g. increasingly negative swap spreads and the record use of Fed's reverse repo facility, indicating a scarcity of safe collateral). In addition, the regional heterogeneity of macro-financial conditions provides some structural diversification effect. However, diversification effects are likely to diminish significantly in the event of a full-fledged economic recession.

Figure 20: Tail dependence as proxy for global systemic risk



Sources: Refinitiv Datastream, Allianz Research
Note: * Co-movement component of the third-order moment across 40 assets (EQ & Commodities)

Capital Markets Summary Table

year-end figures	Last	Unit		Baseline	
EMU			**2021**	**2022f**	**2023f**
Government Debt					
Policy rate (ECB deposit rate)	0,75	%	-0,50	1,50	1,25
Policy rate (MRO)	1,25	%	0,00	2,00	1,75
10y yield (Bunds)	1,73	%	-0,2	2,40	1,80
10y EUR swap rate	2,51	%	0,3	1,80	1,50
Italy 10y sovereign spread	226	bps	136	245	225
France 10y sovereign spread	56	bps	37	65	50
Spain 10y sovereign spread	113	bps	77	80	70
Corporate Debt					
Investment grade credit spreads	192	bps	98	180	145
High-yield credit spreads	534	bps	331	550	450
Equity					
Eurostoxx (total return p.a.)	-14.8 ytd	%	23,4	-15	7
US			**2021**	**2022f**	**2023f**
Government Debt					
Policy rate (upper)	2,50	%	0,25	4,00	3,00
10y yield (Treasuries)	3,42	%	1,5	3,25	2,90
Corporate Debt					
Investment grade credit spreads	146	bps	98	150	130
High-yield credit spreads	468	bps	310	475	400
Equity					
S&P 500 (total return p.a.)	-16.6 ytd	%	28,7	-13	8
Foreign Exchange					
EURUSD	1,002	$ per €	1,137	1,01	1,10
UK			**2021**	**2022f**	**2023f**
Government Debt					
Policy rate	1,75	%	0,25	2,50	3,00
10y yield sovereign (Gilt)	3,2	%	1,0	3,00	2,25
Corporate Debt					
Investment grade credit spreads	200	bps	115	200	150
High-yield credit spreads	601	bps	390	600	475
Equity					
FTSE 100 (total return p.a.)	3.1 ytd	%	18,4	2	4
Emerging Markets			**2021**	**2022f**	**2023f**
Government Debt					
Hard currency spread (vs USD)	319	bps	295	370	320
Local currency yield	6,9	%	5,72	7,3	6,5
Equity					
MSCI EM: total return p.a. in USD	-18.3 ytd	%	-2,2	-17	9

Sources: Refinitiv Datastream, Allianz Research

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Allianz Research encompasses Allianz Group Economic Research and the Economic Research department of Allianz Trade.

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