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ECONOMIC INSIGHT

2023 Economic Outlook

Advanced economies are navigating the dual challenge of high inflation and a weakening growth outlook. High rates of inflation have caused central banks to raise interest rates exceptionally quickly and, in most cases, tightening is likely to continue based on near-term data, suggesting downside risks to economic growth in 2023. This is the cost of central banks trying to drag inflation meaningfully lower. The inflation outlook is critical and will define just how much economic pain central banks will have to risk before they potentially pivot. While there is emerging evidence that the peak in inflation is behind us, the speed at which it decelerates will be a key signpost for investors.

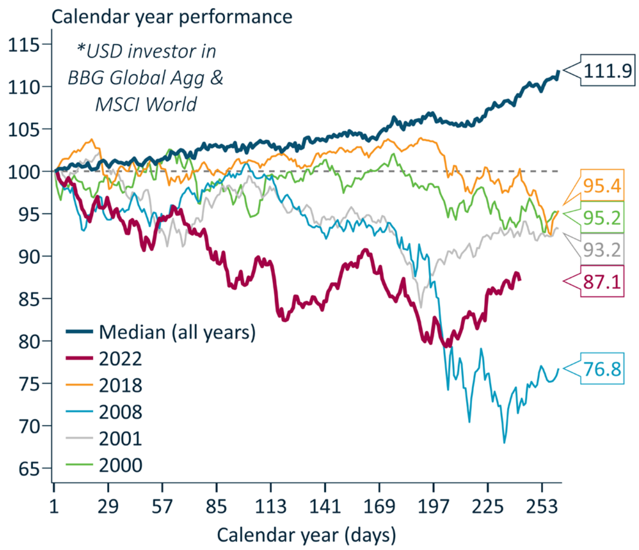
Asset class correlations made 2022 a challenging year for investors

2022 was one of the most challenging years for a long time for many investors, particularly given there was no outright recession. Nonetheless, the key driver was still economic in nature: the difficulty of pricing 'stagflation' and the consequent policy response into the economic outlook. The year was defined by this narrative from the outset, with key advanced economy government bond yields rising rapidly and equity markets selling off as investors realised that central banks were intent on raising rates exceptionally quickly to get inflation back under control.

Rising risk-free rates, coupled with rampant inflation and a weakening economic outlook, prompted increasing correlations across both growth and defensive asset classes, leaving investors with few places to hide. Indeed, 2022 was one of the worst years on record for the traditional '60/40' portfolio in terms of outright returns and we believe economic risks are only building as we enter 2023.

GRAPH 01 **GLOBAL 60:40 PORTFOLIO***

Lack of asset class diversification was costly in 2022



Source: IFM Investors, Bloomberg, Macrobond

Inflation and monetary policy still key in 2023

In 2023, we expect markets to remain highly sensitive to inflation and monetary policy considerations. However, in the near-term, we view further significant selloffs in equity and bond markets as unlikely and are looking for some modest improvement as pressures recede in global markets, with better-than-expected economic data and peaking inflation exerting less pressure on central banks.

The temptation for investors to engage in these risk-on moves is understandable. The equity market sell-off in 2022, particularly in the US and Eurozone, has reset valuations so they no longer appear as stretched as they were in the peak-pandemic stimulus period. Further, while equity markets may not yet have bottomed, investors seem to believe that further modest declines are manageable, particularly if they are based on the expectation of a softer landing than is currently being priced.

Bond yields have similarly moved higher due to central banks tightening policy to neutral levels (or beyond) in response to elevated inflationary pressures. In bond markets there is also an expectation forming that yields have peaked and being wrong about this in the current environment is likely to be less costly than it was when rates were lower. This view appears to be consensus amongst investors who are expecting an economic downturn in 2023.

Whilst a 'pivot' from central banks, most notably the US Federal Reserve, is being watched-for — and may indeed prompt a further rally across both bond and equity markets— such a 'Goldilocks' outcome of a less aggressive tightening cycle based on well-behaved economic data and inflation is not our base case view.

We expect that the pivot will only come as the data flow deteriorates and the negative outlook painted by the soft data is realised in the hard data. And even then, central banks will want to be certain that the reduction in economic output and increases in unemployment rates are material enough to convincingly drag inflation lower.

The economic risks around this central bank strategy are high and a recession is still possible. Implementing aggressively tightening policy and judging when to stop by observing the concurrent data flow is inherently risky, particularly because policymakers are relying on weaker activity to push inflation lower. Inflation based on weaker demand is a very lagged indicator, so central banks that make assessments on inflation alone will probably be behind the curve, heightening the downside risks to economic growth.

This is particularly true as monetary policy makers are likely to err on the hawkish side to prevent any chance of a wage-price spiral and to keep inflation expectations anchored. They are also likely to keep rates elevated for an extended period to ensure their inflation objectives are met.

So, the question is not whether inflation will abate in 2023, as it almost certainly will, but rather by how much we can expect it to abate and over what timeframe. This point is key for any central bank pivot and potential reversal of policy tightening. And on this front, there is considerable disagreement.

GRAPH 02 **ADVANCED ECONOMY RECESSION PROBABILITY**

Recession expected, a matter of when and how deep

Source: IFM Investors, Bloomberg, IMF, Macrobond

How quickly will inflation get back to target?

To date, there has not been widespread evidence of outright wage-price spirals that would entrench inflation. But in jurisdictions where wages have accelerated materially, central banks must act at the margin given how prominent labour costs are for many businesses. The supply shocks from the pandemic and energy costs are also clearly having an indirect impact, pushing prices higher.

Despite some of these costs retracing as demand falls, supply chains gradually improve (and potentially evolve) and energy and commodity prices ease, businesses will be likely to be slow to pass these lower costs on to consumers. This is already evident, with inflationary pressures becoming increasingly broad-based across goods and services categories in CPI measures globally. This suggests there is a clear risk that inflation remains above-target—though probably not egregiously above-target— for several years.

We do not believe that inflation will remain structurally higher in the post-pandemic world despite several arguments, ranging from demographic impacts to onshoring/friendshoring supply chains being proposed as structural inflation drivers. Although these arguments touch on important economic drivers, the expectation that inflation will be structurally above central bank targets is essentially taking a bet that central banks either can't, or aren't willing to, get inflation to target. We aren't prepared to take that bet.

US Federal Reserve Chair Jerome Powell has been the most vocal of the major economy central bank heads and has signalled a commitment to keep policy tight until there is clear and unambiguous evidence of inflation moving in the right direction, even if that forces the US economy into a recession. A similar argument can be made for other advanced economies, although in the UK and Eurozone it's more a case of how prolonged the recession will be, given that these economies will very probably experience a recession in coming quarters.

Households will continue to shoulder the adjustment burden

Households are likely to continue to bear the brunt of the economic adjustment in 2023. Real disposable incomes have been set back a decade in many countries as sharp cost-of-living increases and higher debt servicing costs bite. The latter is of particular concern for countries with high proportions of variable mortgages and high rates of household indebtedness or both (e.g. Australia).

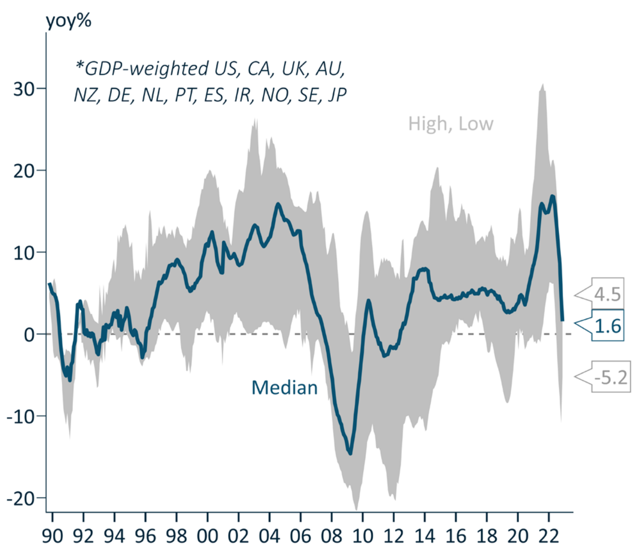
The wealth channel is also negative, as the ratcheting-up of interest rates is causing a synchronised global fall in dwelling prices from the peaks formed in the immediate aftermath of the pandemic as ultra-low interest rates were capitalised into prices. Wealth is also being hit by the fall in global markets that has negatively impacted direct investment portfolios and pensions. Falling house prices and rising rates will also have a sizeable negative impact on housing investment (which is already experiencing significant cost pressures) and given the large multiplier effects associated with this sector, this could be another key driver of the coming economic downturn.

There are two key positive factors supporting households, but these may not last:

- **Continued labour market robustness** - With consumer sentiment at record lows, it is only extreme labour market tightness that has been holding household spending together. But the labour market will not be this tight forever and is set to weaken in 2023 as slower growth weighs.
- **Elevated savings** – This is positive but not a panacea, particularly as a material amount of dissaving has already taken place and people will be less willing to spend their savings if they are uncertain about the future.

GRAPH 03 **ADVANCED ECONOMY DWELLING PRICE INDEX***

Dwelling price falls will continue for some time to come yet



Source: IFM Investors, various national statistical agencies, IMF, Macrobond

If these positive dynamics unwind, a reversal in household sector demand in advanced economies will be likely to be a key driver of any recession.

Investment implications

Given this outlook, it seems prudent for investors to remain overweight defensive asset classes, either cash or government bonds, as we enter 2023[1]. To be overweight duration risk in fixed income, based on our outlook, is justifiable as we see limited further upside to yields and relatively attractive carry in the current market.

More uncertainty lies in the outlook for equities, and arguably credit. Whilst there may be a rally based on central banks winding back some hawkishness, we are not certain how this will be sustained and underpinned by earnings once the economic downturn takes hold. There is a risk that further drawdowns in equities occur after the Fed pivots and, even more so, if the Fed is expected to ease given this implies a deeper downturn than is currently forecast.

We currently expect any recession, at least in the US, to be relatively shallow and short, so the temptation for investors to tilt towards growth assets will build in anticipation of economic recovery. This trade will probably gather momentum as it becomes clear that returns in fixed income are likely to be defined by the pricing of only a shallow easing phase by central banks, assuming inflation slows.

It seems very unlikely that yields will plumb the lows of the pandemic period. Similarly, a period of trend economic growth and receding global liquidity should effectively start weaning markets off monetary stimulus-driven returns. This suggests more moderate returns in growth markets are likely in the post-downturn environment.

Risks to the outlook, outside of domestic economic uncertainly in advanced economies, abound as heightened geopolitical tensions remain. The evolution of the Russia-Ukraine conflict and China's COVID zero policies are key unknowns. We have asserted since the depth of the pandemic that economies will be likely to recover to some sort of post-global financial crisis malaise. While there has been much more volatility than we expected as this occurs, the coming year will be a step towards that environment. The global economy has experienced the upside in the immediate post-pandemic recovery and 2023 threatens to be the hangover that we had to have.

US – Skirting recession

The US experienced a shallow technical recession in 1H22 and although growth subsequently rebounded, recent data suggest underlying demand is softening and the growth outlook is relatively weak. Through 2023, we expect growth to slow to around 0.5% — the weakest rate of expansion, outside of the pandemic, since the global financial crisis. And while recession is not as assured as in some other advanced

[1] Forecasts are based on reasonable assumptions and are provided for informational purposes as of the date of this material. Such forecasts are not a reliable indicator of future performance and are not guaranteed to occur. Please see the "Important Disclosures" for more information.

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economies, risks to the forward view are substantial and several uncertainties remain around inflationary persistence and the resilience of the US economy to higher interest rates.

US inflation has probably peaked and is expected to move consistently, and initially perhaps rapidly, towards the Fed's target. But longer-term progress will be more difficult to achieve, and we expect US inflation to remain well above target for much, if not all, of the coming year. Cognisant of this, the Fed has signalled that it will keep rates restrictive until there is clear and unambiguous evidence of inflation heading back to target, even if that inflicts pain on the labour market and broader economy.

Eurozone – Recession energy

The Eurozone is experiencing slowing growth and accelerating inflation that have both been exacerbated by the Russia-Ukraine conflict. The energy crisis precipitated by this conflict has been one of the defining features of the Eurozone's challenging 2022 and will be likely to define the region's economic prospects in the years to come. The Eurozone's existing energy framework has been shaken to the core and the region will need to undergo a massive structural change to its energy supplies as it shifts permanently away from Russian gas.

Recent data suggest both the immediate pulse of growth and the 2023 outlook may not be as bad as some commentators previously expected. Real output in Q3 eked out a small increase of 0.2%qoq to bring through the year growth to 2.1%yoy. More timely PMI data suggest that although private sector activity contracted in October and November, the rate of contraction was not as poor as expected. These indicators, along with a broad suite of confidence measures, suggest coming quarters will record negative growth, but these should be limited to Q422 and the first half of 2023.

UK – Exceptionally challenging outlook

The UK is very probably already in a recession and, if not, will almost certainly enter a recession over coming quarters. This sets the UK economy up to contract throughout all of 2023, taking the economy backwards by around 1% over the year. This will come with the combination of high inflation, high debt-servicing costs (UK mortgage repayments are more sensitive to short end rates than the US), and a softening labour market. Like most other advanced economies, much of the downturn is being driven by the adjustment forced on households, with soft consumption the key growth headwind.

This bleak growth outlook is probably a necessary evil, as the recession will help bring aggressively high inflation lower. This is sorely needed in the UK case, with the headline inflation rate hitting 11.1% in October. Expectations are for further policy tightening in coming months, but BoE head Andrew Bailey recently pushed back on market expectations of a roughly 5% terminal rate. The BoE believes inflation risks are skewed to the upside, but the pace of future hikes will probably slow, given the already substantial tightening in monetary policy and the weak economic outlook.

Japan – Muddling through

Japan's growth risks are skewed to the downside and include a deterioration in global economic conditions, the ongoing impacts of the war in Ukraine on commodity prices, and the effects of COVID-19 on domestic household consumption. However, the recent relaxation of all COVID containment measures, the re-opening of the international border and some improvement in supply chains (particularly those in the automotive industry and other export sectors) suggest growth will improve going into 2023.

There is considerable uncertainty over the future path of prices, and whether the current inflationary episode is a one-off event. Nonetheless we expect a gradual shift in policy stance from the BoJ in line with its measured actions to date in order to reduce some inflationary pressures and support the JPY. That said monetary policy remain far more accommodative in Japan than other advanced economies given expected economic circumstances. Further, Japan remains more scarred than most other countries by the extended period of below-target inflation and will want to be convinced that expectations have been re-anchored at a higher rate before taking any more aggressive policy action.

Australia – finding the narrow path

In Australia, the cash rate target has increased 300 basis points in the current hiking cycle to 3.1% — a rate not seen for a decade. The RBA remains committed to fighting inflation, which is still well outside the target band. But the RBA is also more cautious than its global peers about overtightening policy and having an undue negative economic impact. So, the RBA is treading a 'narrow path', trying to realise a soft landing. The key to achieving this lies with the uncertain, lagged impact of material interest rate increases on households.

The main uncertainty, aside from domestic concerns, is the deterioration of the global economy and this underpins our expectation that much if not all the RBA's work on tightening policy has been done. We expect the economic data to either drift or deteriorate over the Summer and this will define what the RBA needs to do when it returns in February. Globally, developments in China will be important and headwinds in the Chinese property market could result in lower demand for Australian iron ore and lower national income. The future path of China's COVID policies could also flow through to domestic demand via the return (or lack thereof) of international students and inbound tourists.

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