PICTET WEALTH MANAGEMENT

2023 Global Macro Outlook

A mild recession and a sluggish decline in inflation will keep central banks on alert

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FLASH NOTE

SUMMARY

- We forecast a mild recession in the US and the euro area in 2023, with real GDP contracting by 0.2% in both places. Significant tightening of financial conditions along with the largest inflation shock to real incomes in decades will continue to take their toll on economic activity. On a more positive note, the relatively strong balance sheets of households and corporates should help cushion the recession's impact.
- In the US, we expect household consumption to bend (but not break) as unemployment rises gradually in the second half of next year. In the euro area, the labour market looks resilient and fiscal policy should remain broadly supportive, but the energy shock is too large to offset completely.
- China is facing the short-term risk of a chaotic post-covid reopening, but also structural obstacles to growth due to housing deleveraging and government regulations. We forecast Chinese real GDP to grow by 4.5% in 2023.
- The oil market looks set to be remain broadly balanced in the short term, but rising demand post China's reopening combined with low supply elasticity may boost prices in H2 2023. We expect Brent prices to reach USD115 at end-2023.
- On the heels of the US, we believe that inflation has peaked in the euro area. We continue to forecast global disinflation in core goods as supply constraints ease and demand slows. However, price pressures in labour-intensive service sectors will likely persist into next year. We forecast headline and core inflation to decline to around 3% by the end of 2023, both in the US and in the euro area.
- Central banks will 'keep at it' until there is convincing evidence that core inflation is easing. We see a terminal rate of 5.25% for the Fed fund rate, and 2.50% for the ECB's deposit rate, with upside risks. Even as central banks prepare to slow the pace of tightening, their communication is likely to remain hawkish with a view to keeping inflation expectations anchored. Over the longer run, however, central banks could be tempted to allow inflation to run above their 2% target (to, say, 3%) as the least-worst solution.

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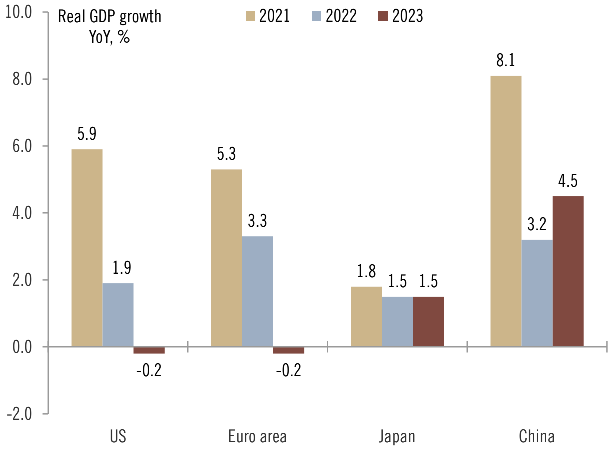
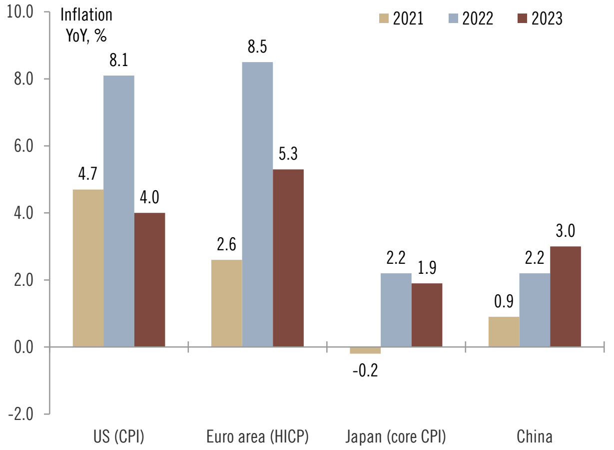
US, euro area, Japan, China: real GDP forecasts



Source: Pictet Wealth Management, 29 November 2022

US, euro area, Japan, China: inflation forecasts



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US: FED RATE HIKES WILL END UP BITING

We expect a moderate US recession in 2023, mostly due to tighter financial conditions stemming from sharp monetary tightening by the Federal Reserve (Fed). The housing sector is likely to feel the biggest pain due to the spike in mortgage rates in the second half of 2022, which is putting downward pressure on property prices and a lid on housing transactions. Accounting for 3.1% of US GDP, residential investment could drop by over 10% in 2023.

The key question for 2023 is whether US consumers keep spending. We do expect some resilience on this score. We think that the gradual depletion of pandemic savings and harder access to credit due to tightening financial conditions will be partly offset by moderating inflation. We expect real consumption to grow by 0.4% in 2023, down from an expected 2.6% in 2022.

As for corporates, souring business sentiment could mean business investment as well as hiring is put on ice, leading ultimately to job losses. **We expect a gradual increase in the unemployment rate, mostly concentrated in the second half of the year**. Overall, we expect real US GDP growth of -0.2% in 2023.

We expect inflation to continue to moderate gradually, to 4.0% on average in 2023 compared with 8.1% in 2022. However, high consumer inflation expectations and relatively sticky wage growth could make the Fed wary about letting down its guard too early for fear that price rises re-accelerate. **We expect the Fed funds rate to stabilise at a terminal rate of 5.0-5.25%**, which could be reached by March 2023. Rate cuts are unlikely before early 2024, in our view.

EURO AREA: A MILD WINTER RECESSION FOLLOWED BY A GRADUAL RECOVERY

The euro area economy grew at strong pace in the first half of 2022 but slowed considerably in Q3 2022 due to high energy prices, record inflation and progressive tightening of financial conditions. The services sector benefitted from pent-up demand following the end of the pandemic, but the hit to households' disposable

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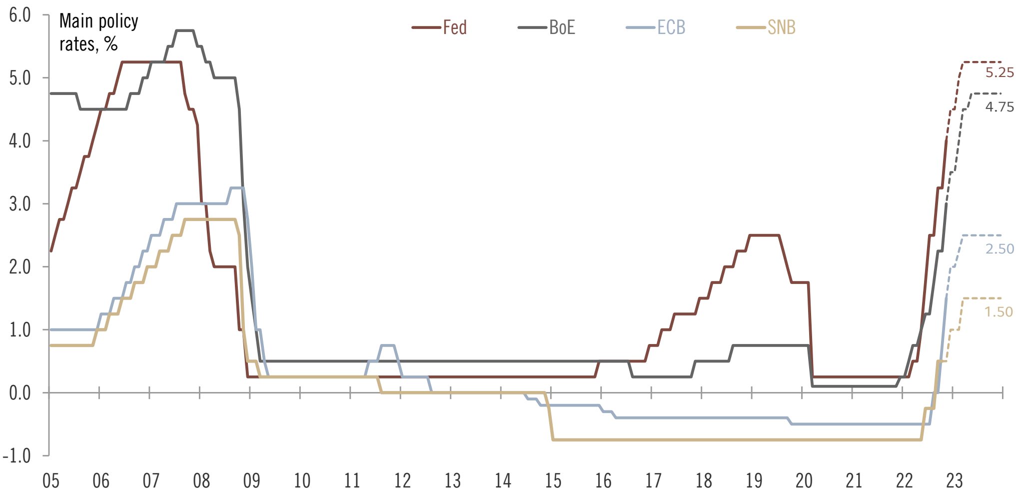
income from high energy prices will push down consumer spending again. Recent data point to a mild recession in the euro area. Larger-than-expected levels of gas storage have reduced the risk of energy rationing this winter. The recovery in H2 2023 is likely to be subdued since government emergency support measures are progressively being removed and the gas supply situation remains fragile. NextGenerationEU, the EU's recovery fund, will continue to support growth, particularly in peripheral countries. In all, we forecast euro area growth of -0.2% in 2023, down from 3.3% in 2022. Country wise, **Germany and Italy will be more affected by the energy crisis than France and Spain**, which are more diversified in terms of energy sources and are both relatively more services-oriented economies.

Slowing growth, lower energy prices and the easing of supply bottlenecks will help moderate inflation. We expect euro area headline inflation to peak in the current quarter and to average 5.3% in 2023, down from 8.5% this year. **Core inflation is likely to ease gradually over 2023 as goods price inflation cools, but continued labour and energy cost pressures mean services inflation could be sticky.** We see core inflation remaining above 2% throughout 2023.

Easing prices pressures could lessen the need for further aggressive monetary policy tightening, with the European Central Bank (ECB) likely to reduce the pace of hiking from 75bp to 50bp in December. **We forecast the ECB to raise its deposit rate to 2.5% by March 2023**, with a risk that the monetary stance has to be tightened further into restrictive territory if fiscal policy turns more stimulative.

Central banks: policy rates including projections



Source: Pictet Wealth Management, Fed, ECB, BoE, SNB, 29 November 2022

ASIA: DIVERGING FORTUNES

The Chinese authorities recently issued a set of measures aimed at providing credit support to property developers and propping up weak growth momentum. These measures may help stabilise the housing sector in the coming months, although a massive rebound is unlikely for structural reasons. On the covid front, the authorities recently made a series of adjustments to covid restrictions, possibly in preparation for an eventual exit from their 'zero-covid' policy (ZCP). But the recent outbreak of large-scale protests against the ZCP could lead to political turmoil ahead.

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The likelihood the re-opening process will be messy adds to the downside risks facing China in the near term. **We expect a moderate pickup in Chinese growth, with our 2023 GDP forecast standing at 4.5%**, up from 3.2% in 2022. Our headline inflation forecast for 2023 is 3.0%, up from 2.2% in 2022.

Japan's moderate recovery will likely extend into 2023. Private consumption may benefit from the re-opening of the economy as households start to spend a significant amount of excess savings, while capex seems to be picking up. The yen's weakness could attract an increased flow of foreign travellers as covid restrictions are lifted. We expect Japanese GDP to grow 1.5% in 2023, the same as this year. We expect price pressure to persist in the coming months, but core inflation could peak in early 2023 and the annual average may settle at 1.9%, after 2.2% in 2022.

The picture in the rest of Asia may be mixed. Waning global demand together with domestic monetary tightening could continue to weigh on North Asian exporting nations like Taiwan and South Korea. India, with a much smaller external sector, will likely be less hurt by declining global growth. Rate hikes by the Reserve Bank of India could pose some near-term headwinds, but there are inklings of a solid upward trend in fixed investment thanks to a pick-up in manufacturing activity. We expect the Indian economy to expand by 6% in 2023 after 7% this year.

Like India, ASEAN economies are enjoying a 'demographic dividend' and could continue to benefit from global supply-chain relocations. Vietnam continues to be a top choice for foreign manufacturers, although in the near term it faces a property-sector slump. Thailand may see a stronger recovery in 2023 thanks to a rebound in tourism. The large-scale inflow of human and financial capital means inflation could continue to run hot in Singapore.

OIL: PRICES TO INCREASE AFTER TEMPORARY WEAKNESS

Economic slowdown in western economies and limited mobility in China due to ZCP have weighed on oil and liquid fuel consumption, which has declined by 2.4 million barrels per day (mbd) globally year to date (ytd). In 2023, demand for oil is expected to increase by 2.4mbd, slightly below 2019 all-time highs.

By contrast, supply has increased by 3.4mbd ytd to 101.6mbd, close to the all-time high reached in late 2018. We expect supply to decline by 1mbd in the short term due to the recent OPEC+ decision to cut production quotas. Meanwhile, US shale oil production looks set to lose steam in 2023. Non-OPEC+ countries are already producing above pre-pandemic levels and their potential for further increases appears limited. Russian production is likely to remain capped by sanctions.

With most OPEC members unable to fulfil their production quotas, spare capacity is concentrated in a few big suppliers - namely Saudi Arabia, UAE and Iraq. In this context, Riyadh is back in the driving seat. OPEC+ is very likely to match a weakening of global demand with further cuts, thus putting a floor under oil prices.

All in all, we expect the oil market to be pretty balanced in H1. By contrast, in H2, increasing demand combined with low supply elasticity is likely to boost prices, with **Brent reaching USD115 per barrel at end 2023**. The downside risks to this scenario for oil prices are plentiful. From the most to the less likely, these are: a deeper global recession than expected, the maintenance of China's ZCP, further sustained expansion of US shale oil production, a settlement in the war in Ukraine, a decision by OPEC+ not to reduce supply, and regime change in Iran.

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