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ECONOMIC AND MARKET OUTLOOK

January 2023

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Developments in the US economy will have an impact not only in the US, but across the globe. While the stateside economy has proven reassuringly resilient until very recently, a recession now looks inevitable within the next twelve months. Against this backdrop, we believe that patience is the order of the day in equity markets. Meanwhile, rising interest rates are a source of opportunity for bond investors.

Economic outlook

United States: a drawn-out fight against inflation

After climbing for two years, US inflation seems to have peaked. Lower fuel prices have allowed headline inflation to slow, while core inflation (excluding food and energy) has stabilised at around 6.0% year-on-year (Figure 1).

Core inflation is coming off the boil as goods prices return to normal (Figure 2). The overheating was a reflection of temporary price rises due to a mismatch between supply and demand prompted by the Covid-19 pandemic. Goods prices can be expected to continue to fall back to normal as production flows improve. That said, the consequences of the Covid-19 epidemic in China still need monitoring.

Meanwhile, services inflation remains high. Labour market tensions would need to ease markedly to enable a return to normal as wages heavily influence the prices charged for services (Figure 3).

In the past, labour market tensions have rarely eased without the onset of recession. Up until the ISM numbers were released for December 2022, the US economy had been proving remarkably resilient. Weekly jobless claims remain very low and we are not yet seeing the fall-off in corporate earnings that usually precedes a recession (Figure 4).

Against this backdrop, we see three possible scenarios. The first is a soft landing, where the economy slows down but avoids contraction. The scenario would enable labour market tensions to gradually ease. The second foresees a mid-2023 recession triggered by recent rate hikes to tighten monetary policy. The third scenario accounts for a more robust US economy that pushes the Fed to continue hiking rates into the second half of 2023. In this case, we place the onset of recession in early 2024. We believe the soft landing scenario to be unlikely (10% probability), and the two remaining scenarios to be equally likely (45% probability each).

Figure 1
United States: consumer Price Index (year-on-year)
Source: Bloomberg

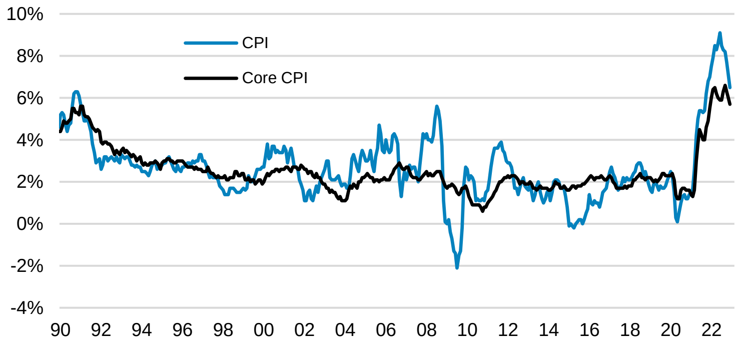


Figure 2
United States: consumer price deflator excluding food, energy, monthly contributions, three month average
Source: Bloomberg

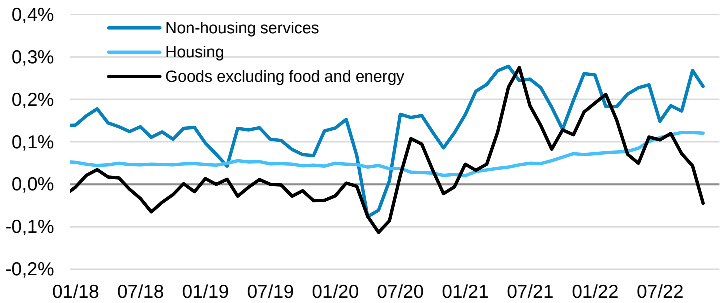


Figure 3
United States: annual changes in service price inflation excluding energy and hourly wages
Source: Bloomberg

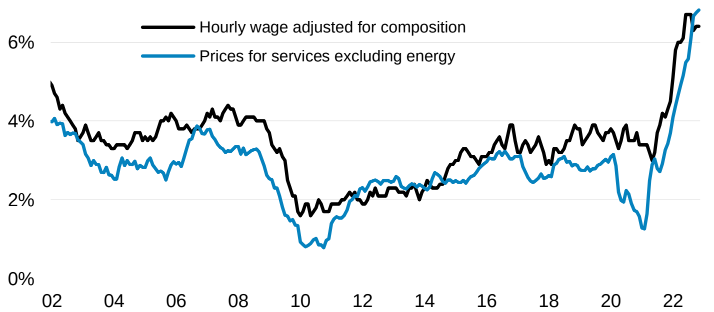
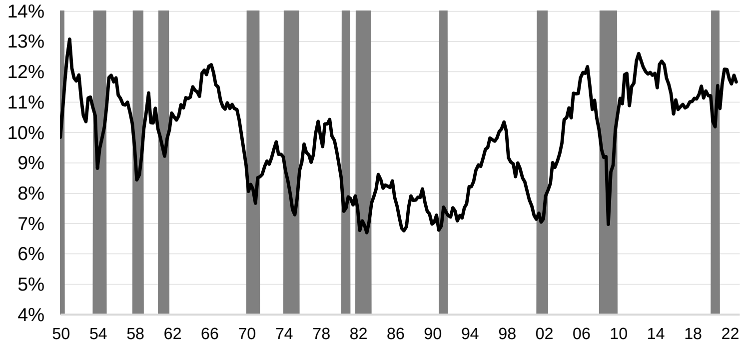


Figure 4
United States: percentage share of corporate profits in GDP
Source: Bloomberg



EUROZONE: RESILIENT GROWTH

Eurozone inflation remains stubbornly high. Unlike in the US, it is closely tied to rising food and energy prices, as shown by the large gap between headline and core inflation (Figure 5).

In all likelihood, headline inflation will slow sharply in the months ahead given that last spring's energy price surge constitutes a very high basis for comparison. It would take another similar spike to reach previous inflation levels (Figure 6).

However, a slowdown in headline inflation does not mean that the problem has gone away. Core inflation remains high and without significant labour market easing, wage pressure could persist (Figure 7).

In line with ongoing labour market tightness, economic growth is holding up relatively well due to Europe navigating the energy shock better than had been anticipated. The data seem to point towards a moderate economic slowdown.

Governments have implemented various measures to support both households and businesses. Reduced gas consumption and efficient storage strategies helped to lessen the threat of winter rationing and ultimately led energy prices to fall (Figure 8).

In addition to lower gas consumption, massive LNG imports were key in avoiding shortages. Given thin capacity for LNG supply growth until 2025, lower Asian demand and especially Chinese demand has facilitated these higher import volumes. The reopening of the Chinese economy could result in a tighter gas market. All told, uncertainties persist and next winter could be challenging.

For this winter, the energy crisis threat appears to be receding and the ECB will probably have to push ahead with tightening its monetary policy. As usual, developments in the US will influence the outlook for the European economy.

Figure 5
Eurozone: inflation (year-on-year)
Source: Bloomberg

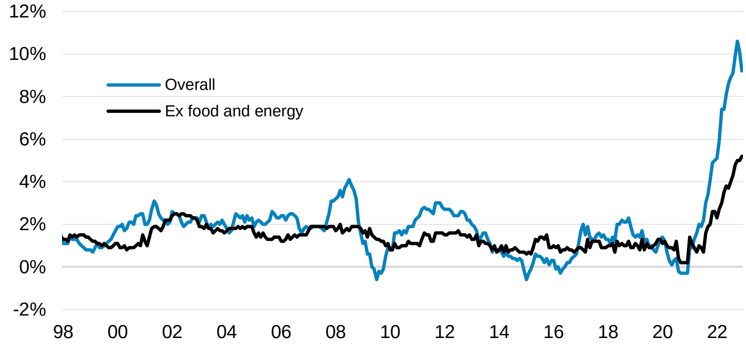


Figure 6
Contribution of food and energy to global inflation (blue line: simulation if prices return to spring 2022 levels)
Source: Bloomberg, Lazard Frères Gestion

Figure 7
Eurozone: unemployment rate
Source: Bloomberg

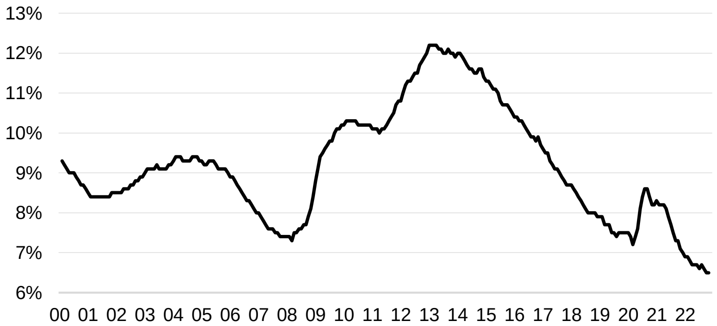
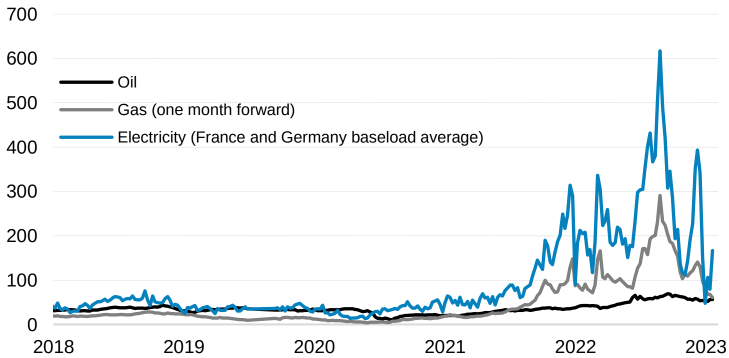


Figure 8
Europe: Europe: energy prices (EUR/MWh)
Source: Bloomberg



China: the road to recovery

The decisions made by Chinese authorities in recent weeks indicate a pro-growth policy shift. The government has abruptly lifted the health restrictions that had been disrupting growth for three years. It also stepped up measures to support the property market.

Ironically, relaxing health restrictions initially prompted a growth slowdown (Chart 9) as people stopped travelling due to catching, or trying to avoid, Covid.

While the reopening will eventually translate into a spending recovery, the timing remains uncertain and depends on how the health situation develops, which is difficult to gauge. A rebound in mobility data suggests that a peak has passed, but further waves cannot be ruled out.

Questions also surround the scale and sustainability of the economic rebound. To what extent will consumers spend surplus savings accumulated during the pandemic? Could structural headwinds, such as population decline, limit the housing sector's ability to recover? (Figure 10)

Conclusion: macroeconomic context

Once inflation has peaked, the problem has not necessarily been solved. Until wage growth slows significantly, or the conditions for such a slowdown are in place, central banks will not be convinced that they have won the battle against rising prices. As such, they view economic strength in the short term as problematic and are likely to remain hawkish.

Over the course of an economic cycle, it is difficult to significantly reduce labour market tensions without the dampening effects of an economic recession. We see the pathway to the most favourable scenario (soft landing and significant labour market easing) as being a very narrow one to tread. Chinese growth will gather pace following an initial hiccup, but probably not enough to compensate for the very likely recession in the West.

Figure 9
China: PMI surveys (official and Caixin average)
Source: Bloomberg

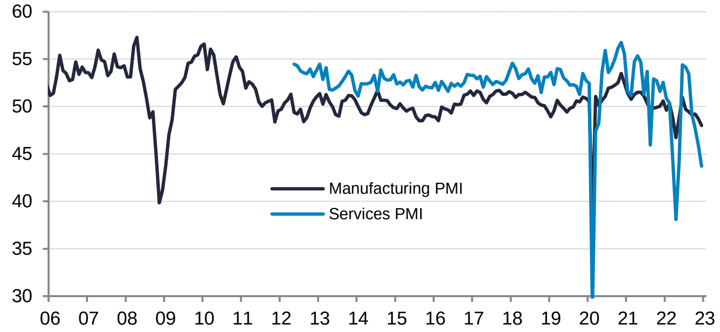
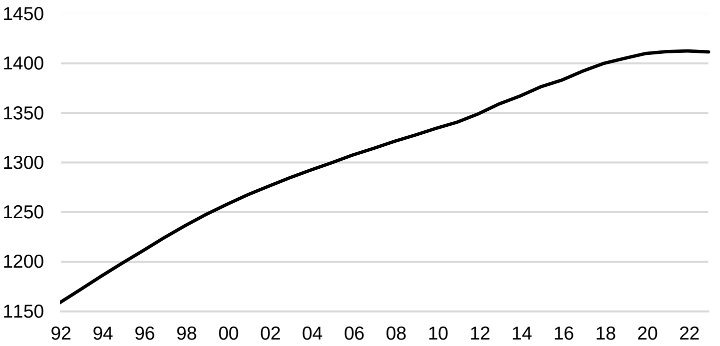


Figure 10
China: total population (million)
Source: Bloomberg



Lexicon

PMI / ISM indices: the PMI (Purchasing Manager's Indices) and ISM (Institute for Supply Management) indices summarise confidence levels among surveyed business purchasing managers. A value above 50 indicates positive sentiment in the sector concerned (manufacturing or services) and below 50 indicates negative sentiment.

Risk premium (equities): the equity risk premium reflects the additional return offered by equity markets compared to the bond market risk-free rate (usually 10-year sovereign bonds). This additional yield compensates the investor for taking more risk.

Credit spread: the difference in yield between a bond and a risk-free loan with the same maturity. The term 'spread' therefore refers to a rate difference or rate differential. The better the perceived creditworthiness of the issuer, the lower the spread.

MSCI World: the MSCI World Index is a stock market index produced by MSCI to measure the performance of global equity markets.

EPS: earnings per share. 12-month forward EPS are the earnings per share expectations linked to earnings forecasts over the next 12 months.

€STR (euro short-term rate): the overnight eurozone interbank rate in the money market.

Market outlook

Bond/currency markets: attractive yields

In the eurozone, the ECB speech on 15 December 2022 was more hawkish than expected, promising further rate hikes and announcing a timetable for balance-sheet shrinkage. However, since the start of 2023, markets have been ratcheting down their expectations for short-term rates. They now price in 125 bps of rate hikes over 2023 (Figure 11).

In the United States, the Fed's December speech was also tougher than expected, mentioning an upwardly revised federal funds rate peak and elevated rates throughout 2023. Market expectations are considerably more moderate, with investors anticipating rate cuts as early as the second half of 2023 (Figure 12).

In Japan, the rise in domestic rates could lead to capital flows returning home with the Japanese repatriating some of their USD 2.4 trillion international bond holdings, which in turn could exert upward pressure on western rates. Indeed, Japanese investors seeking to hedge US dollar exposures are facing effective negative yields on US 10-year notes.

In the credit segment, yields have returned to around 4% for good quality European companies (Figure 13). This could cushion credit spreads from widening back to 2012 levels. Credit spreads for lower quality European companies could still temporarily widen under a recession scenario, although yields are already attractive at around 7%.

In foreign exchange, the euro-dollar continues to move in line with the short-term interest rate differential. A likely upward adjustment in Fed rate expectations could therefore lead to another rebound in the US dollar. In the longer term, we can expect the exchange rate to return to levels more consistent with purchasing power parity, the implication being that a sharp rebound in the euro against the dollar lies ahead (Figure 14).

Figure 11
€STR levels: implied path
Source: Bloomberg

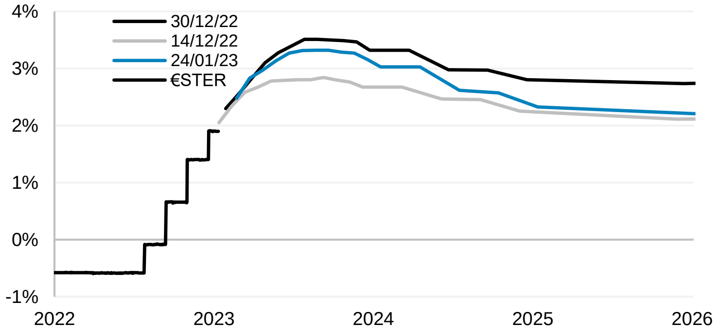


Figure 12
United States: federal funds rate (past and expected)
Source: Bloomberg

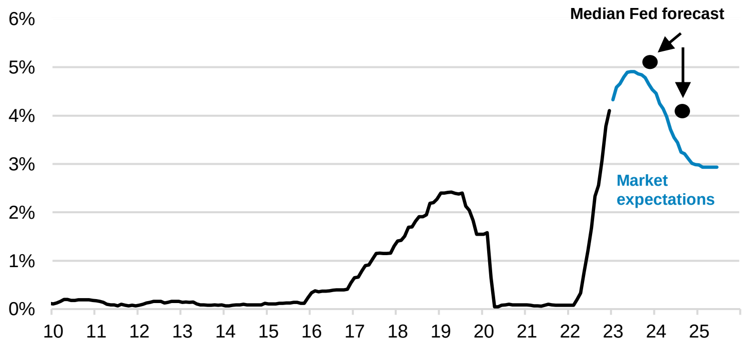


Figure 13
Eurozone: corporate bonds (excl. financeals)
Source: Bloomberg

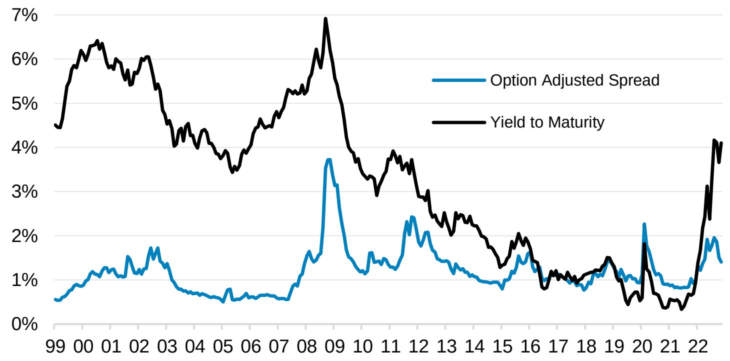
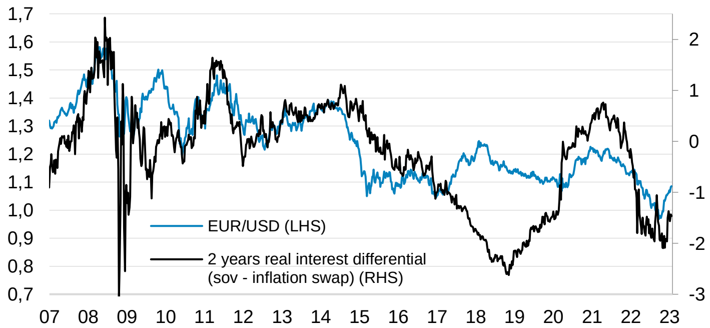


Figure 14
EUR/USD exchange rate and interest rate differential
Source: Bloomberg



OVERLY OPTIMISTIC EQUITY MARKETS?

We believe that earnings expectations for 2023 are too optimistic. While the buoyant start to 2023 may bring further surprises to the upside, an ineluctable recession will, at some point, drag on growth (Figure 15).

In addition, equity market valuations are not especially cheap. Indeed, while the valuations in most markets sit below historical averages, they remain well above recession levels (Figure 16).

As interest rates rise, equity returns become relatively less attractive. European bond–equity spreads are at their narrowest for the past decade and in the US, equity risk premia are very low.

CONCLUSION: FINANCIAL MARKETS

Most asset classes are facing challenging times as central banks raise rates in a bid to combat inflation while concomitantly raising the risk of triggering a recession.

While we cannot rule out positive surprises in the next 3–4 months given the resilience of the economy, we believe that equity markets remain threatened by further monetary policy tightening and a very likely recession in the year ahead. Aside from the fact that valuation lows are usually reached after the onset of recession (Figure 17), current valuation levels do not appear exceptionally cheap. Patience remains the order of the day.

However, given the higher interest rates and widening credit spreads, bonds are currently offering attractive yields. The context calls for a gradual approach to fixed-income investment in the months ahead.

Figure 15
EPS growth and PMI global manufacturing index
Source: Bloomberg, JP Morgan

Figure 16
Equity valuations: earnings multiples (12 month forward P/E)
Source: Bloomberg

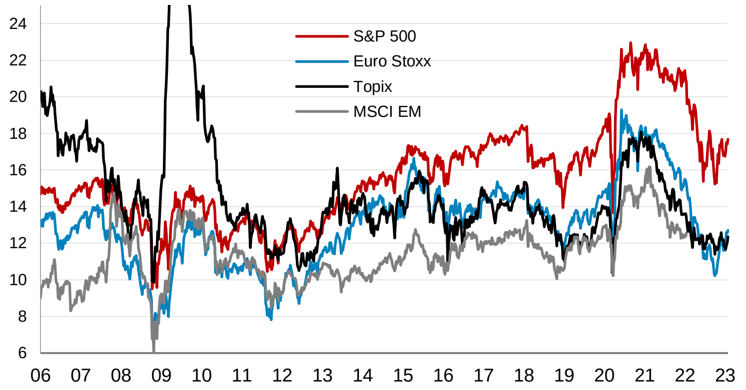
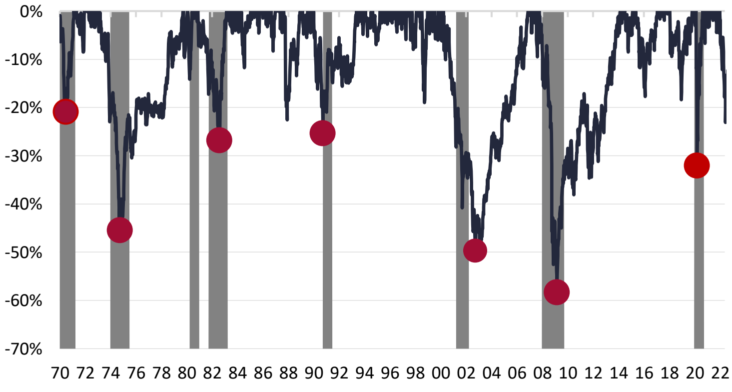


Figure 17
S&P 500 total fall compared to previous peak
Source: Bloomberg



The opinion expressed above is dated January 2023 and is liable to change. Latest available data as of publication date.