ECONOMIC OUTLOOK:
ENERGY, TRADE AND FINANCIAL SHOCKWAVES

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Allianz

EXECUTIVE SUMMARY

Ludovic Subran, Chief Economist
udovic.subran@allianz.com

Ana Boata, Global Head of Economic Research
ana.boata@eulerhermes.com

Andreas Jobst, Global Head Macroeconomic and Capital Markets Research
andreas.jobst@allianz.com

Eric Barthalon, Head of Capital Markets Research
eric.barthalon@allianz.com

Jordi Basco Carrera, Senior Investment Expert
jordi.basco_carrera@allianz.com

Pablo Espinosa-Uriel, Capital Markets Research Analyst
pablo.espinosa-uriel@allianz.com

Alexis Garatti, Senior Economist for ESG and Public Policy
alexis.garatti@eulerhermes.com

Françoise Huang, Senior Economist for APAC and Trade
francoise.huang@eulerhermes.com

Patrick Krizan, Senior Economist for Italy and Greece, Fixed Income
patrick.krizan@allianz.com

Ano Kuhanathan, Sector Advisor and Data Scientist
ano.kuhanathan@eulerhermes.com

Selin Ozyurt, Senior Economist for France and Africa
selin.ozyurt@eulerhermes.com

Roberta Fortes, Economist Latin America
roberta.fortes@eulerhermes.com

Manfred Stamer, Senior Economist for Emerging Europe and the Middle East
manfred.stamer@eulerhermes.com

Katharina Utermöhl, Senior Economist for Europe
katharina.utermoehl@allianz.com

The Russian invasion of Ukraine has brought back significant headwinds to the global economic recovery and raised wider geopolitical risks. We have cut our global growth forecast to +3.3% in 2022 and +2.8% in 2023, revised on the downside by -0.8pp and -0.4pp respectively. The economic implications will be felt above all in Russia, which will plunge into a deep recession this year (at least -8%), especially after comprehensive sanctions have been extended to the energy sector. Almost two-thirds of our downward revision of global growth is due to confidence and supply chains shocks, with the remainder being attributable to higher commodity prices. Global inflation will also prove higher and stickier (6% in 2022, revised up by +1.9pp) due to higher energy prices longer than expected supply chain disruptions, which will contribute to price pressures in equal measure. While current negotiations between Ukraine and Russia could provide a path towards a ceasefire, further escalation cannot be excluded, resulting in even harsher sanctions and counter-sanctions (including on energy supply). In such an adverse scenario, inflation would soar to 7.0% this year while growth would decline to 2.5% before world enters into a recession next year (at 0.3%). Our economic outlook builds on our first coverage of the Russia-Ukraine crisis as early as 24 February, when we provided an analytical framework for the assessment of the macro-financial impact of the war in Ukraine together with revised forecasts for growth and inflation as well as important asset classes. This report extends on our initial analysis and examines the broader implications of the conflict. Our revisions to our economic outlook refer to our last report in January.

We expect global trade growth to decline by at least -2pp in 2022 to +4% in volume terms, just below its long-term average. While Russia as an end-demand market is not systemic globally (representing just 1.2% of total imports), the most exposed exporters in Central and Eastern Europe could still incur considerable losses. Auto production, particularly in Europe, would be affected by shortages of metals and gases critical to the production of semiconductors and other parts. However, net exporters of commodities, such as countries in the Middle East and several Latin American countries, could benefit from higher prices and potential substitution effects away from Russia. The further tightening of sanitary restrictions in China in response to fresh Covid-19 outbreaks could further weigh on trade due to higher input prices and a delayed normalization of supply chains.

Several key developments could add downside risks to our outlook. As a result of trade sanctions on Russia, oil & gas, wheat as well as certain metals and industrial gases have suffered extreme price volatility due to concerns about supply shortages. Natural gas prices in Europe are likely to remain at high levels due to higher dependency on Russia. However, we expect oil prices to gradually decline again over the next few months amid reduced and adjustments of both demand and supply. In the absence of a price reversal by mid-2022, this inflationary shock through imported prices and prolonged supply bottlenecks would continue to diffuse into overall prices and activate a wage-price loop, especially in the UK and France. In addition, renewed Covid-19 restrictions in China could prolong pressures on supply chains and producer prices. We could also see rising volatility around the normalization path of monetary policy in the Eurozone and the US as both central banks embark on rolling back their accommodative stances despite rising concerns about growth. (Geo-)political risks other than the Ukraine war also need close monitoring, including US-China tensions and elections in France and Brazil.

In light of the significant damage to real activity, fiscal and monetary policy decisions will be critical. Most EU countries have extended (and adopted further) fiscal measures of at least 0.6% of GDP on average to help vulnerable households and firms cope with energy inflation. We expect fiscal policy to continue to play a key role over the near term, and to partly mitigate the impact of higher energy prices on inflation and on consumers' disposable income. In our adverse scenario, potential fiscal support could more than double (1.5% of GDP). In the case of our adverse scenario materializing, countries may be forced to intervene to control prices and, in a more extreme case, administer scarce supplies. Despite the continued hawkish shift of the monetary stance in the US and the Eurozone, monetary policy normalization in advanced economies will be slightly delayed if central banks become increasingly concerned about slowing growth. In emerging markets, central banks will continue to fight inflation and currency depreciations through further rate hikes, dampening the growth cycle even further.

In global markets, higher uncertainty has resulted in significant equity and bond market volatility. Under current conditions, we expect continued monetary normalization to stabilize real rates and support equities (on the back of still strong corporate earnings expectations) while long-term nominal rates in advanced economies remain contained by safe haven flows, increasing recessionary concerns and some reversal in spiking inflation expectations. This should also slow current credit spread widening, with investment grade names consolidating at 115-120bps until the end of the year. But in the adverse scenario, equity markets will sharply correct (down by 13-14% until end-2022), safe haven flows will lower benchmark long-term sovereign rates (with the 10-year German Bund at -0.35% and the 10-year US Treasuries at 1.2%) while credit spreads widen to 180-190bps but remain range-bound, thanks to central bank asset purchases.

CEASEFIRE, CONFLICT ESCALATION AND BLACK-OUT SCENARIOS UNPACKED

The Russian invasion of Ukraine has brought back significant headwinds to the global economic recovery and raised wider geopolitical risks. Governments around the world have imposed sweeping and sizable financial and economic sanctions, including partial export embargoes on high-tech goods exports, sanctions against the largest Russian banks, the removal of multiple Russian banks from SWIFT and the freezing of two-thirds of Russian central bank foreign exchange (FX) reserves. Counter-sanctions from Russia have included a mandatory conversion of 80% of FX received in business transactions into rubles, very stringent capital controls regarding payments abroad (including sovereign debt service and banning foreigners from selling securities) as well as the nationalization of foreign companies deciding to exit Russia after the start of the war. While current negotiations between Ukraine and Russia could path the way for ceasefire, further escalation cannot be excluded, resulting in even harsher sanctions and counter-sanctions (including on energy supply).

The economic implications will be felt above all in Russia, with a severe recession of -8% in 2022 resulting in a dramatic deterioration of macro-financial conditions, especially after sanctions have been extended to the energy sector. The ruble continues to depreciate in response to heavily restricted convertibility, collapsing trade and soaring inflation. To preserve financial stability and limit domestic spillover effects, the Russian central bank has doubled the policy rate and provided additional liquidity via repos and loans (with M2 increasing at least by 12% since January; see Figure 1). Capital controls have severely impaired trade with Russia, with sanctions affecting up to 50% of the total volume of services and goods (USD820bn p.a.). The US has recently banned imports of Russian crude oil and other products, and prohibited the financing of foreign companies that are making new investments in Russia's energy sector. The UK has also banned imports of Russian oil but European policymakers have not imposed similar restrictions so far. More than half of Russia's export revenues comes from oil & gas, which generates at least USD750mn in daily revenues, enough to finance one month of Russian imports. However, a complete and effective export ban of all oil & gas exports would leave Russia only two months until it falls short of fiscal revenues (without taking into account the non-frozen international reserves).

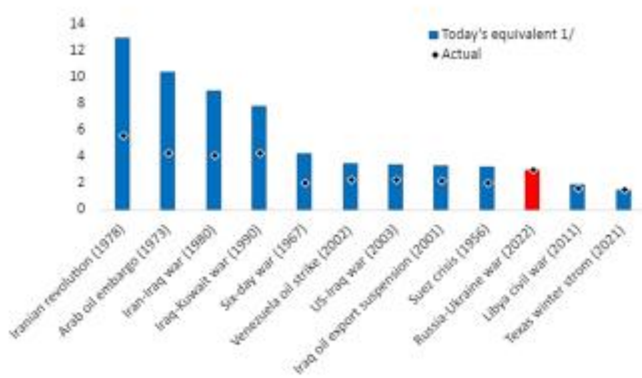
Figure 1: Selected financial indicators for Russia (cumulative change since 30 September 2021)

Sources: Refinitiv, Allianz Research. M2 for February is built on internal calculations based on January M2 and other more frequent monetary releases (Russia's M2 for February is expected to be published on 31 March).

For the rest of the world, and mainly Europe, energy, trade and finance continue to be the main channels of impact:

Commodities. Higher commodity prices and volatility, notably for oil & gas, and the availability of agricultural commodities (wheat, maize, rapeseed, sunflower seeds and oil), for which Russia and Ukraine represent more than 10% of global exports, as well as strategic raw materials (nickel, palladium) have resulted in a significant negative supply shock, especially for European economies. In addition, Russia is the world leader is several key fertilizers (nitrogen, potassium and phosphorous). In the absence of a conflict de-escalation, we expect the contingencies related to the oil & gas supply from Russia, and the lack of a massive supply injection from other OPEC countries, to perpetuate price pressures during the course of the year. However, the potential quantity effect of a Russia-induced oil supply shock would be much smaller relative to past crises after accounting for the declining energy-intensity of production and a lower share of oil in the energy mix (see Figure 2). Oil prices will remain above 100 USD/bbl throughout the war period and are likely to be close to 120 USD/bbl on average in 2022. Gas prices are also likely to remain elevated at close to 140 EUR/MWh (see Figure 3). Since energy represents almost 15% of EU imports (of which Russia supplies 65%), the terms-of-trade shock could completely wipe out the current account surplus under our adverse scenario. At the same time, financial losses to Russia from export restrictions on oil & gas are mitigated by higher prices offsetting lower volumes (even with Russian oil trading at a discount of up to 15%). The EU has so far exempted Russian energy supplies from sanctions, but volatile and spiraling energy prices and potential Russian retaliatory measures will weigh on European business budgets and factory activity because of their reliance on Russian natural gas for power generation[1]. Even if governments (with the help of international financial institutions) step in and reduce the cost of energy for households—and in some cases even for corporates—households' real purchasing power will decline. We estimate that EU households alone will experience higher energy bills (around EUR20bn-EUR30bn extra for the largest EU countries[2]) at current oil & gas prices, which could increase to even EUR50bn, or 2% of GDP, if Russia ceases to export any oil & gas (either because of embargoes or as a retaliatory measures). In addition, declining business confidence will weigh on investment as corporate margins continue to be squeezed in an environment of high energy and non-energy commodity prices, higher wage bills and continued high freight costs.

Figure 2: Historical comparison of oil price shocks (In mn barrels per day of (potential) supply loss)



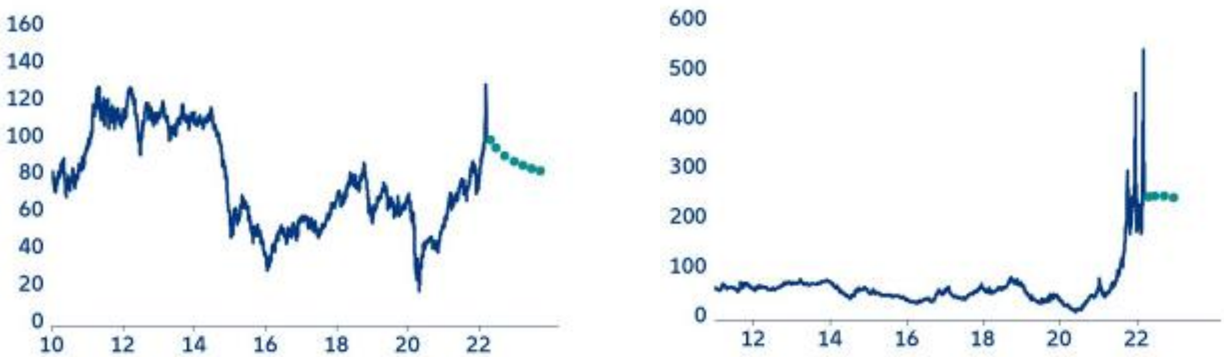
Sources: Enerdata, IEA, Our World In Data, and Allianz Research.

Note: 1/ adjusted for changes in the share of oil in the global energy mix and the energy intensity of production and consumption."

1 *At the Versailles Summit last week, European leaders committed to reducing their energy dependency on Russia until 2027 without cutting back current energy imports.*

2 *See our report The (energy) price of war for European households*

Figure 3: Futures curves of Brent oil (USD/bbl, right) and CE ural gas (BPN/therm, right).



Sources: Refinitiv, Allianz Research

Trade. In addition to the near-term loss of export markets, the current crisis has delayed the normalization of supply chains and is likely to weigh on potential output due to a defensive, resilience-oriented reallocation of resources. Even though supply chains remain stretched compared with pre-pandemic standards, there were signs of stabilization before the invasion. With major container lines rerouting container vessels to less direct and more costly routes to avoid the Black Sea, congestion may increase at other European ports. In addition, air freight is complicated by the EU's and Russia's effective and reciprocal closures of critical airspace, affecting shipping routes between Europe and Asia. The workarounds together with higher energy costs will likely prolong delivery times and pressure freight rates higher. The further tightening of sanitary restrictions in China in response to fresh Covid-19 outbreaks could raise input prices and lead to increased port congestion, as observed in 2021. A repeat of temporary port closures could have ripple effects on the already tense functioning of global logistics. The historical relationship between our in-house China port congestion index and the global manufacturing PMI suppliers' delivery times index suggests that delivery times are likely to remain above the pre-pandemic average for most of 2022, and even lengthen slightly at the start of 2023. Overall, we expect supply chains and confidence shocks to explain close to two thirds of the downward global GDP growth revision, and the remaining from higher commodity prices.

Figure 4: Annual impact on real GDP growth by channel (pp)

Sources: national statistics, Markit, Allianz Research

Thus, we expect global trade growth in volume to be cut by at least –2pp in 2022 to +4%, just below its long-term average. While Russia as an end-demand market is not systemic globally (representing just 1.2% of total imports on average in 2015-2019), the most exposed exporters in Central and Eastern Europe (whose direct and indirect exposures to Russia account for more than 4% of their GDP) could still incur considerable losses. Besides oil & gas, Russia also exports large volumes of fertilizers, metals (e.g., iron, steel, aluminum, copper, nickel and tin) and food commodities (e.g. wheat). Auto production, particularly in Europe, would be affected by shortages of metals and gases critical to the production of semiconductors and other parts. For instance, neon gas and palladium are key raw materials in chip production, and aluminum and nickel, which are used in batteries and other vehicle components, are vital for electric-vehicle production. On the services side, the travel and transport sectors are most exposed. For the Eurozone as a whole, direct and indirect exposures stand below 2% of GDP. Net exporters of commodities such as the Middle East, Norway and several Latin American countries, could benefit from higher prices and potential substitution effects away from Russia.

Finance. We see limited systemic risk for foreign banks. Italian banks have the highest absolute exposure to Russia (around USD25bn) but this accounts only for 2.5% of their total foreign claims. Austrian banks' have the highest share of claims on Russia relative to foreign claims but this is still a moderate 3.7% of total exposures. Based on a bottom-up solvency stress test of the largest 22 banks in Russia (including foreign branches and subsidiaries), we estimate a common equity Tier-1 capital shortfall of up to EUR40bn, which would erode public confidence and add further pressure on Russia's financial system. Looking at foreign direct investment exposures, beyond fiscal paradises, in particular for mining/quarrying, finance and real estate, we find that the Netherlands, the UK and Germany have the highest numbers of foreign affiliates in Russia and Ukraine.

In this context, we cut our outlook for global economic growth in 2022-23. After an expansion of +5.9% in 2021, we now expect GDP growth to slow down to +3.3% in 2022 and +2.8% in 2023. In this baseline scenario ("conflict escalation", 55% probability), in which supply of oil & gas from Russia to Europe is not cut, rising energy prices (close to 120 USD/bbl on average for oil) will dampen aggregate demand in Europe (and to a lesser extent in the US, which is reducing restrictive Covid-19-related measures faster) and further push up inflation. We estimate that the invasion of Ukraine will shave off about -0.8pp of real GDP growth globally in 2022, with the Eurozone being most affected outside Russia and Ukraine (-1.2pp against -0.6pp for the US and -0.3pp for China). Eurozone growth is expected to decelerate to +2.6% y/y in 2022 and to +1.6% y/y next year. We revise up our inflation forecast to 5.5% y/y for 2022 and 2.5% y/y for 2023, reflecting higher food and energy inflation and higher expected feed-through from elevated producer prices to core goods. Beyond developed markets, we expect substantial contagion risk to emerging markets due to rebalancing. Eastern European currencies are expected to suffer most as high commodity prices have supported Latin American currencies. Emerging markets are also entering this new crisis with scarring effects from Covid-19 as they have been lagging the 2021 recovery. In our adverse scenario (black-out, 35% probability), we assume that a further reduction in the carve-outs for energy trade with Russia could become a big oil shock, leading to stagflation morphing into a recession early next year in all advanced economies, as well as commodity-importing emerging market countries. For the Eurozone, we would see inflation at 6.5% y/y in 2022 and 4.0% y/y in 2023. Growth would decelerate from +1.5% y/y this year before a contraction sets in next year (-1.2% y/y). Our economic outlook builds on our first coverage of the Russia-Ukraine crisis as early as 24 February, when we provided an analytical framework for the assessment of the macro-financial impact of the war in Ukraine together with revised forecasts for growth and inflation as well as important asset classes. This report extends on our initial analysis and examines the broader implications of the conflict. Our revisions to our economic outlook refer to our last report in January.

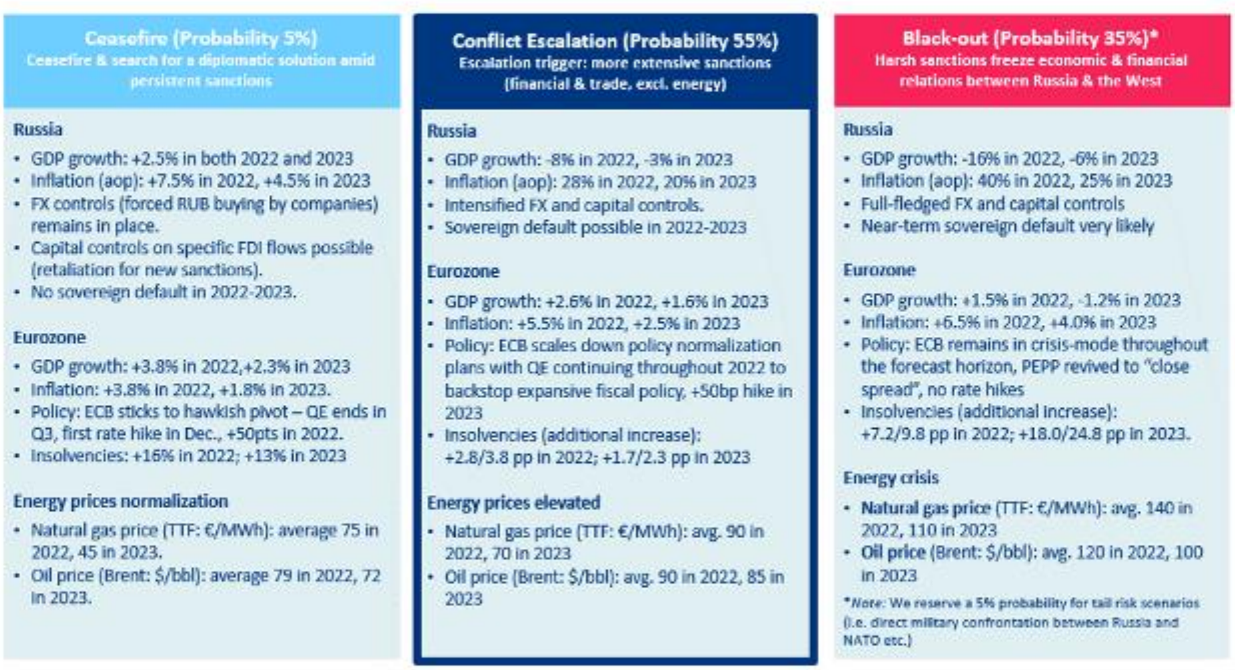
We expect non-payment risk to increase further, given the economic slowdown, with the impact on business insolvencies in the Eurozone to increase by +7pp and +4pp in 2022 and 2023 respectively in our baseline scenario in the absence of new support measures. This will reflect uneven trends due to diverse initial conditions, with insolvencies already rebounding in 2021 in Italy (+19 y/y) but still at a low level in Germany and France at the start of 2022 after another drop in 2021 (-12% y/y for both countries). In 2022, insolvencies would increase by +4% y/y in Germany, +8% in Italy, and +28% in the UK. In France, the various support measures to companies announced March 16 will delay the normalization previously expected and maintain insolvencies at a low level in 2022 (31,000 cases). The US would record a limited rebound in business insolvencies (+7% y/y). Most of emerging markets and smaller European countries should see business insolvencies back to pre-Covid-19 levels as soon as end-2022 in the absence of a "whatever it takes" state support measures. However, if our adverse scenario materializes, business insolvencies would be +5/10pp higher in 2022 and +15/25pp in 2023 to a maximum of +26% and +38% respectively.

Table 1: Business insolvencies forecasts (selected countries)

number of cases, thousands		2019	2020	2021	Conflict Escalation 2022f	Conflict Escalation 2023f	Black-out 2022f	Black-out 2023f
US		22.7	21.6	14.3	15.3	18	16.6	23.2
Germany		18.7	15.8	14	14.6	16.1	15.3	18.2
Italy		10.5	7.2	8.5	9.2	10.7	9.6	12.1
UK		22.1	15.7	16.2	20.8	22.2	22.5	27.6
China		11.8	12.0	8.7	8.7	9.6	9.1	12.1
France	*without support measures*	51.4	32.0	28.2	37.4	51.0	38.8	57.6
	with support measures				31.0	42.0		

Source: Allianz Research

Figure 5: Scenarios



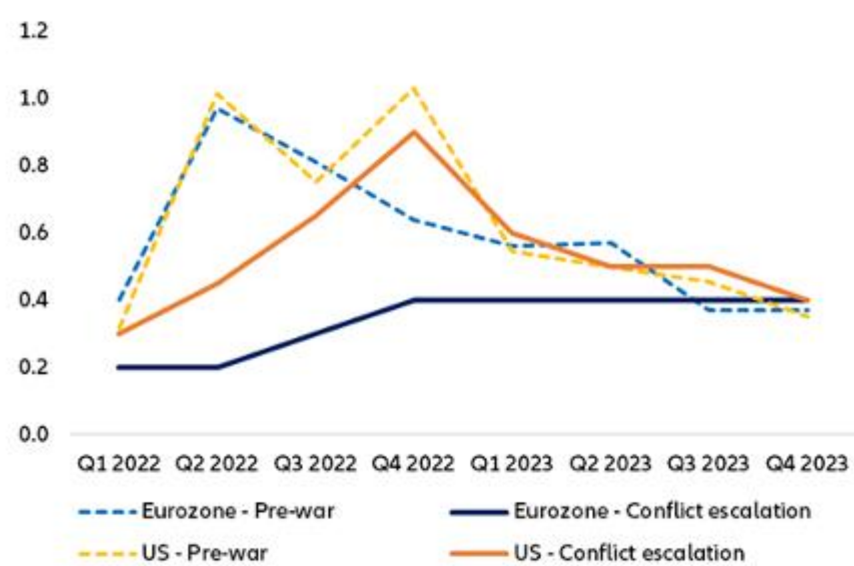
Source: Allianz Research

Table 2: Global growth forecasts

	Conflict Escalation (55%)						Blackout (35%)			
	2020	2021	2022f	*Revision from pre-war*	2023f	*Revision from pre-war*	2022f	*Revision from pre-war*	2023f	*Revision from pre-war*
Global	**-3.4**	**5.9**	**3.3**	***-0.8***	**2.8**	***-0.4***	**2.4**	***-1.7***	**-0.3**	***-3.5***
USA	**-3.5**	**5.7**	**3.3**	***-0.6***	**2.6**	***-0.2***	**2.3**	***-1.6***	**-0.6**	***-3.4***
Latin America	**-6.9**	**6.5**	**1.7**	***-0.7***	**2.0**	***-0.6***	**1.2**	***-1.2***	**1.6**	***-1.0***
Brazil	-4.1	4.8	0.2	*-0.4*	0.9	*-0.3*	-0.3	*-0.9*	0.4	*-0.8*
Eurozone	**-6.5**	**5.2**	**2.6**	***-1.2***	**1.6**	***-0.7***	**1.5**	***-2.3***	**-1.2**	***-3.5***
Germany	-4.9	2.9	1.8	*-1.4*	1.6	*-0.8*	0.9	*-2.3*	-1.4	*-3.8*
France	-8.0	7.0	3.0	*-1.0*	1.5	*-0.4*	1.9	*-2.1*	-1.2	*-3.1*
Italy	-8.9	6.5	2.6	*-1.4*	1.2	*-0.9*	1.4	*-2.6*	-1.4	*-3.5*
Spain	-10.8	5.0	3.9	*-1.6*	1.9	*-1.4*	1.7	*-3.8*	-1.0	*-4.3*
UK	-9.9	7.1	3.2	*-1.2*	2.0	*-0.6*	1.4	*-3.0*	-0.8	*-3.4*
Russia	-2.7	4.7	-8.0	*-11.0*	-3.0	*-5.5*	-16.0	*-19.0*	-6.0	*-8.5*
Turkey	1.8	11.0	1.4	*-0.1*	3.9	*-0.3*	1.0	*-0.5*	1.4	*-2.8*
Asia-Pacific	**-1.0**	**6.1**	**4.6**	***-0.1***	**4.5**	***-0.2***	**3.7**	***-1.0***	**0.9**	***-3.8***
China	2.3	8.1	4.9	*-0.3*	5.0	*0.0*	4.2	*-1.0*	1.8	*-3.2*
Japan	-4.7	1.7	2.2	*-0.3*	1.8	*0.2*	1.2	*-1.3*	-0.6	*-2.2*
India	-7.3	8.9	7.5	*0.4*	6.9	*0.0*	5.9	*-1.2*	0.9	*-6.0*
Middle East	**-4.5**	**3.3**	**4.5**	***0.6***	**2.7**	***0.2***	**4.7**	***0.8***	**2.9**	***0.4***
Saudi Arabia	-4.1	3.3	5.6	*0.9*	2.7	*0.3*	5.9	*1.2*	3.0	*0.6*
Africa	**-2.6**	**3.1**	**3.4**	***-0.2***	**2.7**	***-0.3***	**2.5**	***-1.1***	**2.3**	***-0.7***
South Africa	-6.4	4.6	2.0	*-0.1*	1.5	*-0.1*	2.0	*-0.1*	1.5	*-0.1*

Source: Allianz Research

Figure 6: Quarterly real GDP growth forecasts,%



Source: Allianz Research

Table 3: Global inflation forecasts

	Conflict Escalation (55%)					Blackout (35%)			
	2021	2022f	*Revision from pre-war*	2023f	*Revision from pre-war*	2022f	*Revision from pre-war*	2023f	*Revision from pre-war*
Global	**3.3**	**6.0**	***1.9***	**3.3**	***0.9***	**7.0**	***3.0***	**5.4**	***3.0***
USA	**4.7**	**6.1**	***1.3***	**2.5**	***0.5***	**7.0**	***2.2***	**5.0**	***3.0***
Latin America	**12.0**	**10.6**	***1.3***	**6.8**	***2.0***	**13.5**	***4.2***	**10.6**	***5.8***
Brazil	8.3	7.7	*1.7*	4.0	*0.5*	10.1	*4.1*	7.5	*4.0*
Eurozone	**2.6**	**5.5**	***1.7***	**2.5**	***0.7***	**6.5**	***2.7***	**4.0**	***2.2***
Germany	3.2	6.0	*2.2*	3.2	*1.2*	6.8	*3.0*	4.3	*2.3*
France	2.0	4.3	*1.0*	2.6	*0.5*	5.9	*2.6*	3.6	*1.5*
Italy	2.0	5.2	*1.6*	2.2	*0.7*	6.1	*2.5*	3.7	*2.2*
Spain	3.1	5.0	*1.1*	2.2	*0.8*	6.3	*2.4*	4.1	*2.7*
UK	2.6	7.5	*2.0*	3.5	*1.0*	7.8	*2.3*	4.8	*2.3*
Russia	6.7	28.0	*21.5*	20.0	*15.8*	40.0	*33.5*	25.0	*20.8*
Turkey	19.4	51.7	*32.2*	19.0	*5.2*	57.0	*37.5*	22.0	*8.2*
Asia-Pacific	**1.6**	**3.1**	***0.2***	**2.6**	***0.2***	**3.6**	***0.7***	**4.6**	***2.2***
China	0.9	2.6	*0.1*	2.2	*0.2*	3.1	*0.6*	4.5	*2.5*
Japan	-0.2	1.1	*0.3*	1.1	*0.2*	1.3	*0.5*	1.7	*0.8*
India	5.4	5.6	*0.4*	5.2	*0.3*	6.6	*1.4*	8.3	*3.4*
Middle East	**12.2**	**12.9**	***4.7***	**9.4**	***4.7***	**13.5**	***5.3***	**9.9**	***5.2***
Saudi Arabia	3.1	2.1	*0.4*	2.4	*0.9*	2.5	*0.8*	2.9	*1.4*
Africa	**4.5**	**9.2**	***0.5***	**7.5**	***0.6***	**12.3**	***3.6***	**8.9**	***2.0***
South Africa	5.2	6.5	*0.7*	4.6	*0.3*	7.0	*1.2*	5.2	*0.9*

Source: Allianz Research

Several key developments could add downside risks to our outlook. Several factors could push inflation even higher: the permanent costs of resilient rather than efficient supply chains, downward price rigidities in concentrated sectors and lower productivity due to inefficient resource reallocation. In the absence of a price reversal by mid-2022, this inflationary shock through imported prices and prolonged supply bottlenecks would continue to diffuse into overall prices and activate a wage-price loop. The diffusion patterns from past shocks warn that the UK and France are most at risk of a wage-price loop.[3] In our baseline scenario, we factor in that the wage-price loop would already add +1pp in to annual inflation in the UK and +0.5pp in France by end-2022. In 2023, the contribution will decelerate along with lower imported inflation. In the black-out scenario, with persistent high price pressures throughout the year, the wage-price loop would be stronger and increase annual inflation by +1.5pp in the UK and +1pp in France in 2023. We find that in the US, though wages react strongly and immediately to upward prices, weak feedback from wage increases to prices alleviates the overall wage-price loop. However, there is a risk that this reaction might not work this time around as labor shortages could take two years to fully normalize.[4] In addition, renewed Covid-19 restrictions in China could prolong pressures on supply chains and producer prices. We could also see rising volatility around the normalization path of monetary policy in the Eurozone and the US as both central banks embark on rolling back their accommodative stances despite rising concerns about growth. On fiscal policy, a highlight includes EU fiscal framework reform discussions, which have taken on even greater importance as additional defense spending might derail the planned fiscal adjustment. As far as the "known unknowns" are concerned, aside from the significant socio-economic and political implications of the Ukraine war, the exit from the Covid-19 crisis is likely to take center stage in national polls.

4 *See our report Frying pan to fire: Will inflation spark a wage-price spiral in 2022?*

5 *See our report The (energy) price of war: When inflation bites US savings*

(Geo-)political risks other than the Ukraine war also need close monitoring. US-China tensions never really disappeared and the war in Ukraine is fueling fresh decoupling momentum. Indeed, President Biden's administration is potentially considering reactivating Section 301 with respect to industrial subsidies that the Chinese government may distribute to key strategic sectors or technologies. That would imply potential import quotas on Chinese products. This comes in the context of higher US tariffs against China still being in place (on more than USD370bn worth of imports), further tariff hikes being unhelpful in the current inflationary environment and China having only met 57% of the imports target agreed in the 2020 Phase One Deal.

- China's positioning in the invasion of Ukraine may also further complicate relations between the two governments. In addition, domestic factors that could fuel US-China tensions are at play, with the US mid-term elections and the 20th Party Congress in China both taking place in November this year. Lower household confidence in the US due to very high inflation, and a slowing Chinese economy with downside risks, point towards a harsher tone of communication on both sides against the strategic competitor.

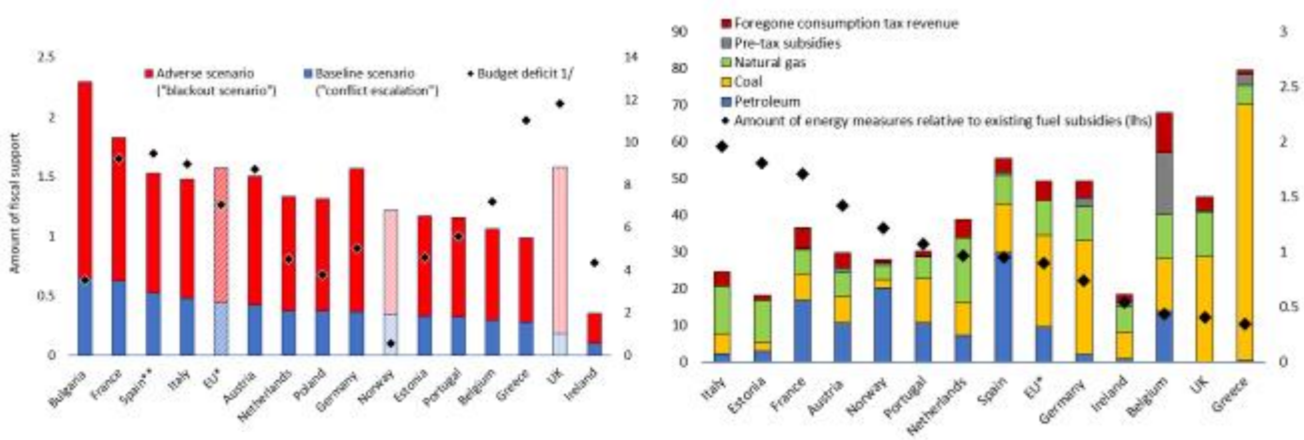
- French Presidential elections that will take place on 10 and 25 April will hardly be a game-changer for national and European politics. In the challenging context of war in Ukraine, preserving purchasing power continues to dominate the candidates' economic programs. The French government will soon reveal the details of its "Resilience Plan" to shield household incomes from energy price hikes. So far, the government announced more than 1% of GDP (at least EUR26bn) of measures to curb energy-price increases for households and targeted companies. However, if prices do not recede in H2 2022, we expect the total cost to double in the absence of targeted measures for households. In addition, public sector support measures that were introduced during the Covid-crisis have been restored to address potential cash-flow issues for most impacted corporates (state guaranteed loans, partial unemployment and delayed social contributions). With close to full employment, the labor market outlook is set to remain positive in 2022 despite the war. President Macron recently announced that he would pursue the delayed pension reform in his second mandate – at least by raising the retirement age from 62 to 65 years old. Apart from this electoral risk, bringing public finances in order remains a largely overlooked topic by almost all presidential candidates. The path to speeding up the transition to renewable energies also lacks a clear roadmap and action plan. Since the onset of the war in Ukraine, President Macron appears to be leading in voting intentions, reflecting a preference for stability and continuity. Latest developments also bring support to Macron's pro-EU policy stance as well as his backward shift in favor of nuclear energy. In addition to fostering industrial and sanitary independence after the Covid-19 crisis, fostering energy and military sovereignty will become a European policy priority.

- In Latin America, we identify the upcoming presidential elections in Brazil, due to be hold on 02 October, as an additional source of instability for the country. Polls show that former president Luiz Inacio Lula da Silva (Lula) has performed strongly and has consistently appeared ahead of the current president Jair Bolsonaro in both first and second round simulations. Mishandling of the Covid-19 crisis hit the government approval rate which, in addition to current and foreseen poor economic performance, makes a second mandate of the president less likely. That being said, elections are still seven months away and Bolsonaro's past statements to local media signal that elections might be tense and, hence, that the country may face increased political risk and volatility in the coming months.

In light of the significant damage to real activity, fiscal and monetary policy decisions will be critical.

Fiscal policy. Most EU countries have extended (and adopted further) fiscal measures to support vulnerable households and firms to an average of at least 0.6% of GDP (Figure 6). We expect fiscal policy to continue to play a key role over the near term, and to partly mitigate the impact of higher energy prices on inflation and on consumers' disposable income. In our adverse scenario, potential fiscal support could more than double to 1.5% of GDP on average. Most governments have already implemented ad hoc packages to help households cope with higher energy bills (Table 4). For instance, in France, the government capped retail gas prices while also temporarily cutting electricity taxes (TICFE). Similarly, Spain's government cut the VAT on electricity bills from 21% to 10% and reduced the electricity tax from 5.1% to 0.5%. It also extended the suspension of the 7% generation tax until end-June 2022 and the additional discount on electricity bills for vulnerable and very vulnerable households. In Germany, the government agreed on a EUR13bn energy relief package on 23 February, which includes higher subsidies for commuters and workers with low incomes and the abolition of the renewable energy surcharge on consumers' electricity bills ("EEG Umlage"). Further support measures are about to be announced. In Italy, the government has already been providing subsidies for consumers and firms since Q3 2021.

Figure 7: Europe: announced and expected fiscal support to mitigate energy inflation and comparison with current fuel subsidies



Source: Allianz Research

Table 4: Europe: Overview of fiscal measures

Country	Measures
France	• **Regulation**: (1) temporary price caps on regulated energy in late 2021 and 2022 (such as cap on the price of gas until April 2022); (2) 4%-cap on increases in regulated tariffs in 2022 (Dec. 2021); (3) Électricité de France (EDF) obliged to increase by 50% electricity sold to competitors to ensure preferential purchase price for alternative producers (from 2022 H2) • **Expenditure**: (1) one-off voucher (€110) for energy bills for 5.8mn households that already receive energy vouchers in Dec. 2021; (2) one-off transfer (€100) for 38 million persons (with net earnings <€2,000/month) in Dec. 2021 and early 2022 • **Revenue**: n.a.
Germany	• **Regulation**: safeguard consumer protection in cases where suppliers try to profit from contract expiries or competitor insolvencies • **Expenditure**: one-off grants to lower-income households, students and apprentices (paid during summer 2022) (EUR 130mn) • **Revenue**: 43%-reduction of the renewable energy surcharge *(Renewable Energy Sources Act)* in Jan. 2022, which accounts for 10.7% of electricity prices, resulting in average household savings of €300 p.a. The cost of €3.3bn will be funded by the Federal budget and higher carbon emissions pricing; a phase-out of the surcharge is planned (starting in July 2022 instead of Jan. 2023, worth €6.6bn)
Italy*	• **Regulation:** n.a. • **Expenditure**: (1) means-tested support for up to 3.5mn households and SMEs (€0.5bn) • **Revenue**: (1) temporary reduction of natural gas and electricity surcharges to fund renewable energy subsidies; (2) reduction of VAT to 5% for natural gas; (3) business tax credit for all energy-intensive companies experiencing a >30%-price increase in Q1 2022 relative to 2019 (equivalent to 20% of the costs of energy consumed in Q1 2022); (4) reduced system costs and taxes for large users (>16.5 kWh)—cost of €1.2 bn largely funded by diverting income from auctions of carbon emission certificates; (5) higher corporate taxes on energy companies that have benefited from surging power prices
Spain	• **Regulation**: (1) price caps on gas and minimum supply guarantee of electricity for lower-income households (11.5mn households); (2) greater transparency in energy markets (consumers to be informed of modification of contracts one month prior to the change by retail electricity and gas companies); (3) plans to require energy firms to supply a certain amount of energy in auctions below the wholesale market price • **Expenditure**: (1) higher transfers ("social bonus") to reduce the electricity bill of vulnerable consumers (until March 31, 2022) (1.2mn households); (2) higher direct aid covering the thermal bonus to vulnerable households (avg. of €90 per beneficiary) • **Revenue**: (1) reduction of VAT (from 21% to 10%) and electricity tax (from 5.1% to 0.5%), as well as suspension of 7% energy generation tax (June 2021); (2) tax on excess profits of energy firms used to fund energy transfers to consumers and new energy infrastructure investments (until April 2022).

Source: Allianz Research

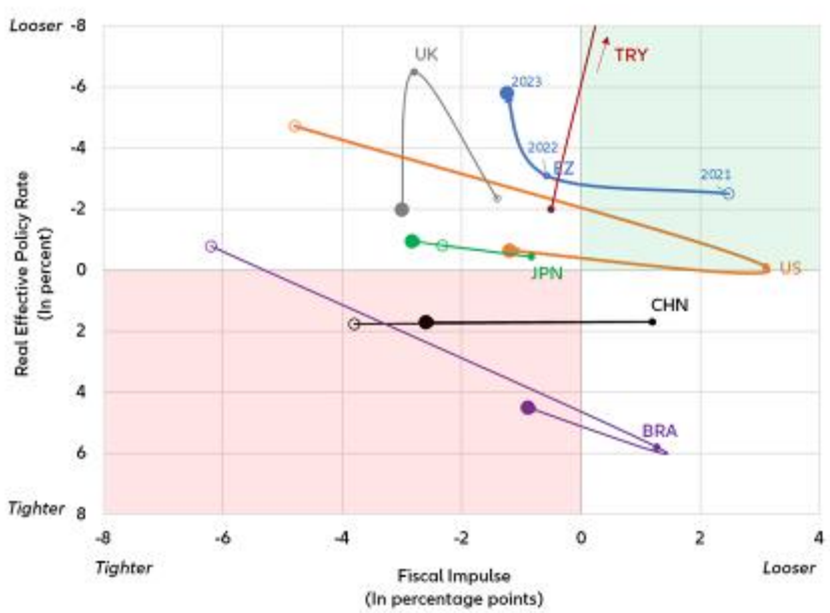
*Note: */ Italy: short-term measures worth €3bn to offset expected increase in retail power prices until the end of 2021, funded by targeting the general electricity sector (€2bn) and lower natural gas bills (€480mn). Additional measures in 2022 Q1 amount to €5.5bn.*

Photo by Alex Vasey on Unsplash

Monetary policy. Monetary policy normalization in advanced economies will be slightly delayed if central banks become increasingly concerned about slowing growth. In the emerging world, central banks will continue to fight inflation and currency depreciations through further rate hikes, dampening the growth cycle even further. After the last policy meeting, the ECB's "hawkish wait-and-see" attitude suggests that inflation concerns are dominating rising economic risks – for now. The risk of backtracking on the current QE guidance is high as the ECB's forecast seems benign. We have maintained our call for the ECB for now, which sees QE continued until year-end and a first rate hike only in Q1 2023. Fiscal support would help the ECB resolve this dilemma by cushioning growth, which will likely bring forward expectations of normalization. The decoupling between the US and Europe continues as asymmetric effects of the cost of war allows for a faster normalization of the policy mix in the US. However, the risk of policy mistakes remains high everywhere.

In global markets, higher uncertainty has resulted in significant equity and bond market volatility, as well as rising safe haven flows. Higher inflation expectations have pushed down real rates and kept credit spreads range-bound. Commodity prices (oil, gold) remain elevated and reflect concern about supply constraints. Long-term yields have shown unusual volatility torn between rising inflation expectations and safe haven flows. Elevated asset swap spreads indicate strong demand for safe collateral). Under current conditions, we expect continued monetary normalization to stabilize real rates and support equities (on the back of still strong corporate earnings expectations) while long-term nominal rates remain contained by safe haven flows and some reversal in spiking inflation expectations. This should also slow current spread widening, with investment grade corporate spreads reverting back to 120bps by the end of the year. In the adverse scenario, equity markets will sharply correct, safe haven flows will lower benchmark long-term sovereign rates while credit spreads widen but remain range-bound, thanks to central bank asset purchases.

Figure 8: Monetary and fiscal stances in large advanced and emerging market economies (2021-23)



Source: Refinitiv, Euler Hermes, Allianz Research

US, EUROPE, CHINA, AND EMERGING MARKETS: REGIONAL OUTLOOKS

US

We expect the US economy to grow by +3.3% in 2022 and +2.6% in 2023, a -0.6pp and -0.2pp downward revision compared with our pre-war scenario, respectively. We estimate the impact of this conflict on the US economy via the confidence channel and the oil-price-shock. We first study the impact of a world economic policy uncertainty shock on GDP growth and inflation to factor in a major geopolitical source of risk in our macroeconomic scenario. This confidence factor affects domestic demand via lower household purchasing power and higher uncertainty weighing on business investment plans. We estimate that the confidence and supply chain shocks imply a -0.4pp downward revision of our US GDP growth scenario. Further, the increase in energy prices would shave off -0.2pp to growth. The shock on domestic demand is likely to be absorbed via expansionary initiatives on the fiscal side: We expect the Build Back Better program to be reduced in size (we pencil in USD1trn instead of USD1.6trn in our previous scenario) but frontloaded in the next five years (instead of 10 years) and spent in separated programs targeting tax cuts on energy and energy companies, social transfers for those with lower incomes as well as new infrastructure programs to accelerate the energy transition toward a more sustainable and self-sufficient macroeconomic model. In total, including already budgeted infrastructure plans, we expect a fiscal impulse equivalent to 1.2% of US GDP both in 2022 and 2023.

We revise up by +1.3pp US inflation to 6.1% in 2022 and by +0.5pp to 2.5% in 2023. The oil price will add +1.5pp to inflation, while the trade and supply chains channel adds +1.4pp and the confidence channel subtracts -1.6pp. The post-Covid-19 inflation shock is temporary, as suggested by the labor force supply progressively normalizing and inflation expectations remaining well-anchored. The tightening of monetary policy will progressively help control the situation. Despite the shock of uncertainty, the Fed will not deviate from its announced program of rate hikes and the reduction in the size of its balance sheet. After the +25bps-rate hike on March 16, we expect the Fed to hike five more times in 2022 and four times in 2023 (each time +25bp). Our expected hiking cycle reflects a greater focus on inflation, which would gradually give way to supporting aggregate demand (resulting in fewer hikes next year). The reduction of the Fed’s balance sheet would start as early as mid-2022, with a reduction of USD10bn per month.

A black-out scenario would see US GDP growth at +2.3% in 2022 and -0.6% in 2023. If the trade embargo against Russia is fully adopted by G7 countries, we pencil in a peak price of USD180 for oil and EUR280 for gas. Following that full stop period, prices should consolidate. The US is less dependent on Russian energy compared to Europe. Over the past 12 months, imports of oil from Russia accounted for only 8% of total imports. Despite the lower exposure, though, the shock should be significant: a 3 standard deviation shock for oil and trade disruption channel coupled with a stronger confidence shock. A recession would occur between Q4 2022 and Q1 2023, leading to a negative growth performance of -0.6% in 2023 (inflation remaining above 5%). In such a situation, the Fed would backpedal in H2 2022 with two rate cuts after two rate hikes in H1. In 2023, the status quo would prevail both in terms of balance sheet policy (constant size) and rate policy.

Eurozone

The Eurozone will be the hardest-hit region in terms of the growth and inflation. We have revised down our Eurozone GDP forecast to +2.6% in 2022 (-1.2pp compared to previous forecast) and +1.6% in 2023 (-0.7pp). The most direct hit to GDP growth comes from the sharp drop in trade flows between Russia and the Eurozone as a result of (i) sanctions, (ii) the self-sanctioning of corporates and (iii) lower expected demand for EU exports from recession-stricken Russia. With less than 2% of total exports from large Eurozone economies destined for Russia, the overall impact will be relatively moderate. However, some sectors that heavily depend on inputs from Russia or Ukraine – think cable harnesses for auto production – will face heightened supply-chain stress.

However, more worrying is the indirect impact of rising commodity prices on economic activity. We have revised up our Eurozone inflation forecast to 5.5% in 2022 (+1.7pp) and 2.5% in 2023 (+0.7pp). Household purchasing power stands to take a notable hit, despite fiscal policy measures to the tune of 1% of GDP that will partially cushion the blow to consumer spending. Negative confidence effects related to heightened geopolitical uncertainty will reinforce the negative economic impact by keeping the private sector cautious about tapping into the excess savings accumulated during the pandemic. Instead, households will cut back on their spending plans – notably on energy-intensive non-essential consumption like air travel, dampening in turn the summer rebound – while corporates will delay (or where feasible shelve altogether) their investment plans.

While 2022 was shaping up to be the year in which policy support would be gradually reined in, the consequences of the invasion of Ukraine call for a second act. In addition to further measures to reduce the pass-through of high energy wholesale prices to consumer prices, we expect a strong increase in investment spending on defense – with more countries following Germany's EUR100bn lead – and energy security. As a result, the Eurozone budget deficit should come in at 5% of GDP in 2022. The set-up of fresh EU financing instruments to fund spending on energy security and defense is in our view premature. For one, member states should first agree on a common vision and clarify the needed joint investments. Moreover, as a first resort, the EU Recovery and Resilience Plan's unused capacity of EUR200bn should be tapped while the flexible application of fiscal rules in 2023 provides some additional breathing space.

The ECB meanwhile will likely prefer to err on the dovish side, despite the further expected pick-up in inflation. It can afford to do so, given that there is still little evidence of second-round effects in Europe as inflation expectations remain largely anchored, and labor market slack should keep upward pressure on wages, and in turn core inflation, in check. In the second half of 2022, we expect QE tapering to gain traction and to be concluded by end-year. A first 25bp rate hike will take place only in Q1 2023, with a second one following in June of next year.

In our adverse scenario, the sharp energy-related supply-side shock could see the Eurozone slip into recession in H2 2022 as aggregate demand adjusts to higher energy prices and power rationing could be introduced. Fiscal policy support would be further stepped up in this situation but would not prevent rising credit impairments. In this scenario, inflation would average at 6.5% y/y in 2022 and 4.0% y/y in 2023 while growth slows to +1.5% y/y this year before a contraction next year (-1.2% y/y). In such a scenario, the ECB would shelve its policy normalization plans for 2022 altogether in light of a meaningful disruption of the economic recovery and growing financial stability concerns in the region, continuing monthly asset purchases throughout the forecast horizon while refraining from raising rates.

Fragmentation remains a significant a risk for the Eurozone. The Ukraine crisis has led to some convergence of sovereign risk premia. Core sovereigns with economic, financial and geographic exposure saw rising spreads (Austria, Finland). Peripheral spreads clearly declined against the backdrop of potential further European fiscal integration flanked by ECB quantitative easing. However, this moment of convergence was wiped out with the ECB's decision to move forward the end of its bond purchases. The Euro sovereign risk premium (GDP weighted 10y Eurozone yield vs 10y OIS swap rate) rebounded, turning positive again. The dispersion of risk premia within the Eurozone (-60bps for Germany, +105bps for Italy) underlines that the financial fragmentation remains a substantial problem. A new convergence push will no longer come from the ECB, but from further fiscal mutualization. However, this is only likely to take place to a significant extent in the black-out scenario (Figure 9).

Figure 9: Eurozone: sovereign risk premia

Sources: Refinitiv Datastream, Allianz Research

Germany

The German economy was already facing an elevated recession risk even before Russia's invasion of Ukraine. Now, fresh supply-chain disruptions, even higher energy prices (inflation will average 2.2pp higher than previously expected at 6% in 2022 and 1.2pp higher at 3.2% in 2023) and elevated economic uncertainty will add to recovery headwinds at a time when the return to pre-Covid-19 GDP levels remains incomplete. We now forecast GDP to grow by +1.8% in 2022 (a downward correction of -1.4pp) – thanks in large part to a carryover of 1.1% from last year – and +1.6% in 2023 (a downward correction of -0.7pp).Fiscal support tested during the pandemic – from furlough schemes to grants for sectors hurt by sanctions – and complemented with measures aimed at shielding consumers from high inflation (including a gasoline rebate, abolishing the Renewable Energy Act (EEG) levy earlier than planned, offering grants to low-income households and increasing the commuter allowance) will help cushion the impact on growth. Safeguarding the recovery will come with a hefty price tag: We expect the budget deficit to come in around 3% of GDP – or twice that at 6% when factoring in off-balance sheet spending on defense and greening the economy.

France

In France, rising energy and input prices had already started to feed into other prices in February. Since the onset of the war and the related energy-price shock, we have revised our inflation forecast up significantly to 4.3% (+1.0pp) for this year and 2.6% (+0.5pp) next year. Ahead of the Presidential elections in April, the French government will maintain significant fiscal support to household and corporate incomes through the "Resilience Plan". So far the government has announced more than 1% of GDP (at least EUR26bn) of measures to curb energy-price increases for households and targeted companies. However, if prices do not recede in H2 2022, we expect the total cost to double in the absence of targeted measures for households. In addition, public sector support measures that were introduced during the Covid crisis have been restored to address potential cash-flow issues for most impacted corporates (state guaranteed loans, partial unemployment and delayed social contributions). In this context, the budget deficit is likely to hover around -7% of GDP in 2022, without a noticeable improvement from the previous Covid-19 years. Despite strong public support to households, rising energy prices will take a toll on consumption in France. Hence we expect economic growth to reach +3.0% (-1pp) this year and +1.5% (-0.4pp) in 2023.

Italy

The Italian economy was feeling the effects of rising commodity and energy prices well before Russia's invasion of Ukraine. Not only did growth in Q4 2021 surprise on the downside with a strong deceleration (+0.6% q/q after +2.5% q/q in Q3), but the economic environment was also deteriorating further as shown by the strong contraction of industrial production in January (-3.4% m/m). For the first time since January 2021, the production level fell below the pre-crisis level seen in February 2020. Given this bad start to year, geopolitics and Italy's high dependency on Russian energy supply (despite first fiscal measures to cushion the energy price shock) make a GDP contraction in the first quarter of 2022 very likely. Thanks to carry over, we still expect GDP growth to reach +2.6% this year, but this is -1.4pp low than previously expected.

Spain

Spain's Covid-19 recovery has been lagging behind that of its neighbors: In Q4 2021, GDP was still 4% below the pre-crisis level even as the Eurozone aggregate had already recovered. This year was expected to step up the economic recovery, fueled by a strong expected rebound in tourism as the rollout of vaccines has helped bring the pandemic largely under control across the Eurozone. The war against Ukraine, however, has scaled back Spain's prospects for vibrant catch-up growth in the coming quarters, which will push up risks of scarring effects in the tourism sector. With reduced household purchasing power (we expect inflation in Spain to rise to 5% in 2022 and 2% in 2023), and elevated economic uncertainty weighing on private consumption dynamics in Spain and abroad, we now expect Spanish GDP to expand by only +3.9% in 2022 (-1.6pp) and +1.9% (-1.4pp) in 2023.

Photo by Anders Jilden on Unsplash

Box 1: Europe's energy dependence and inflation

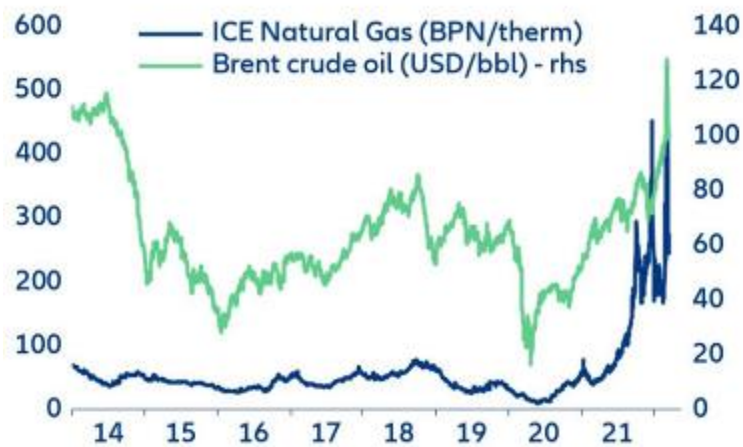
Europe's energy dependence on Russia represents the key risk driver to the inflation and growth outlook. Despite the small share of energy products in total imports, Russia accounts for more than one-third of the value of imported natural gas in the Eurozone. Even though gas represents only about 10% of final energy consumption, gas prices have a material impact, especially if currently elevated levels persist (or rise even higher). This is amplified by the central role of gas in the price setting of electricity in Europe: In most countries, gas has become the marginal fuel in the energy sector. We estimate that a 30% increase of energy prices (oil & gas) will increase headline inflation in the Eurozone by 1pp and reduce growth by 0.5pp after one year.

Given the high variation of gas in the energy mix across the Eurozone, higher energy prices will have a disparate impact on households' disposable incomes and corporate margins. This could not only lead to lower consumption and investment but also increase divergence across countries and complicate the coordination of monetary and fiscal policies. We compute a vulnerability score considering the shares of energy in inflation, of natural gas in energy consumption and of Russia in extra-EU imports and find that the CESEE countries and Germany are the most vulnerable (Table 4).

We expect at least a +30% increase in the energy bill for 2022, with low-income households in the UK and Germany being most affected. Compared to the pre-war situation, for the average consumer, this represents an additional loss of -2pp in the UK, -1.5pp in Germany and -1pp in France, Italy and Spain. In our adverse scenario where energy supply is partially cut, energy prices would increase by an additional 70%; disposable incomes for the average European household would decline by an additional -2.5pp. This would bring the total cost to more than -4pp in the UK and Germany. For more than half of households, excess savings are not enough to absorb the income squeeze from higher energy bills. Without further state support measures, the resulting reduction in consumer spending could cut GDP growth by -0.6pp in the UK, -0.5pp in Germany and -0.4pp in France, Italy and Spain. In the worst-case scenario, the cost to growth from lower consumer spending could reach up to -1.1pp.

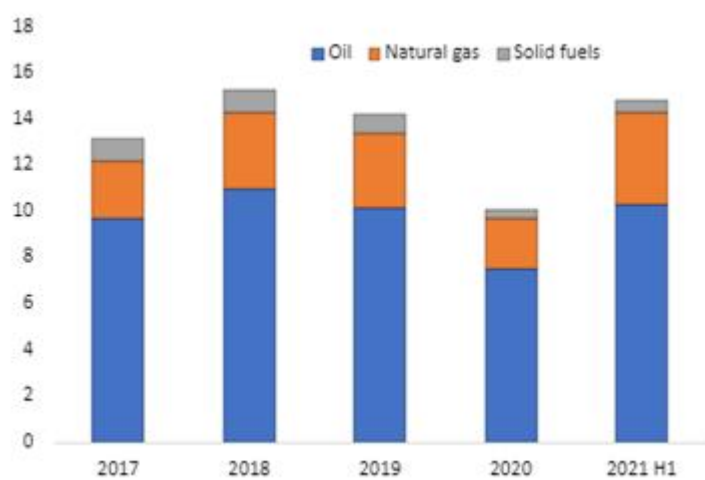
On the corporate side, we estimate that the rise in oil prices in 2022 (up by 60 USD/bbl or +70% compared to 2021) will drive up producer prices in Q2 (+14pp in the Eurozone and +8pp in the US, relative to January levels of +30.3% in the Eurozone and +9.7% in the US). Much will depend on corporates' pricing power, which we believe will prove more limited compared to 2021, given slowing demand. At current energy price levels, the metals and power sectors could suffer the most due to low pricing power, but sea transportation, oil & gas, agrifood, airlines and household equipment would also lose more than -10pp of their EBITDA margins if energy prices remain at current levels throughout 2022 and they do not manage to increase selling prices. Higher energy and commodity prices could also lead to lower demand for some goods and services. Indeed, consumers could delay or simply cancel some non-essential spending and second-round effects from such a confidence shock could harm retail, textiles or services related to recreation (tourism, travel, restaurants and other leisure).

Figure 10: European oil and gas prices



Sources: Refinitiv, Allianz Research

Figure 11: Share of energy products in total EU imports (in value terms, %)



Sources: Eurostat, Allianz Research

China

In China, we cut our forecast for real GDP growth in 2022 (-0.33pp to +4.9%) but continue to expect +5.0% in 2023. The revision is the result of both domestic and external pressures building up, which could potentially lead to further downward revisions. Domestically, the continued spread of the more infectious omicron variant in the context of China's zero-Covid policy will continue to keep a lid on the recovery of private demand. Additionally, even though the worst of concerns may be behind us, we expect the property sector to continue to be a drag on overall economic growth. Bright spots in the domestic economy might stem from infrastructure investment (thanks to policy support) and manufacturing investment. Risks to the latter are now also skewed to the downside, given higher commodity prices in the context of the invasion of Ukraine, and the manufacturing sector's exposure to exports. Though we still expect robust export growth for China in 2022, slower global demand and geopolitical uncertainty could act as headwinds.

As a result of the increased downside risks, we expect the policy mix to continue to ease more aggressively. This accommodative bias was further confirmed at the annual "Two Sessions" meetings, which officially set the 2022 growth target at a rather ambitious "around +5.5%". On the fiscal side, proactive support will be implemented through tax cuts and increased spending. Local government special bonds worth around 3% of GDP will be issued to fund infrastructure investment in areas such as high-tech manufacturing, digitalization, food security, energy, transportation and public housing. On the monetary side, we expect continued active management of liquidity through open-market operations but also another broad-based 50bp cut in the reserve requirement ratio (RRR) this year. Further targeted RRR cuts to small-sized banks are also likely, given the PBOC's focus on supporting SMEs. At least another 10bp cut in the policy rate (1-year MLF rate) should also be expected in 2022. This accommodative monetary policy framework is unlikely to be constrained by excessive inflationary pressures (we expect 2.6% in 2022, compared with a non-binding ceiling of "around 3%"), nor nor significant CNY depreciation risks (thanks to solid external account fundamentals and sufficient FX reserves). All this policy support is likely to help cushion the downwards pressures on the Chinese economy, though not fully make up for them.

In the adverse scenario where the slowdown of the Eurozone and the US economies is much sharper (leading to full-year contractions in 2023), China's real GDP growth would slow to +4.2% in 2022 and +1.8% in 2023. Policy support may prove too slow and/or insufficient to properly smooth the growth path, leading to a more significant deceleration of the Chinese economy. A sharper slowdown of the Chinese economy could also be provoked by the potential inability to quickly contain the ongoing Covid-19 outbreaks. Strict sanitary restrictions in Shenzhen and the Jilin province that have already been implemented as of 14 March 2022 and that last for longer (e.g. one month) could bring China's 2022 GDP growth down towards +2.5%, all else equal.

Emerging Markets

Emerging markets are in different positions to weather the current crisis. The war in Ukraine and large-scale sanctions against Russia will have knock-on effects on other EMs through various channels (see Figure 12 for an overview). Net importers of energy, metals and food may experience rising fiscal and external imbalances. Higher energy and food prices will also stoke inflation in all EMs and trigger further monetary tightening, especially in Emerging Europe and Latin America where real policy rates are still negative (see Figure 13). Moreover, they can lead to an increase in social risk in developing economies with a high share of food and fuel imports. After all, the new shocks add to already existing challenges for some EMs. We find that Eastern Europe as well as Turkey, Morocco, Tunisia, Egypt and Pakistan will bear the highest economic cost of the war through various channels. However, EM net commodity exporters will benefit from higher prices and substitution effects (even in absence of sanctions on some commodities as markets began to shun Russian exports).. A clear example of this are the Latin American countries, such Brazil, Mexico and Colombia (for oil); Chile (for copper) and Argentina (for wheat). However, the price spike is likely to be temporary and, if accompanied with declined aggregate demand, could cause a global slowdown that in the end may wipe out all the initial benefits derived from higher prices.

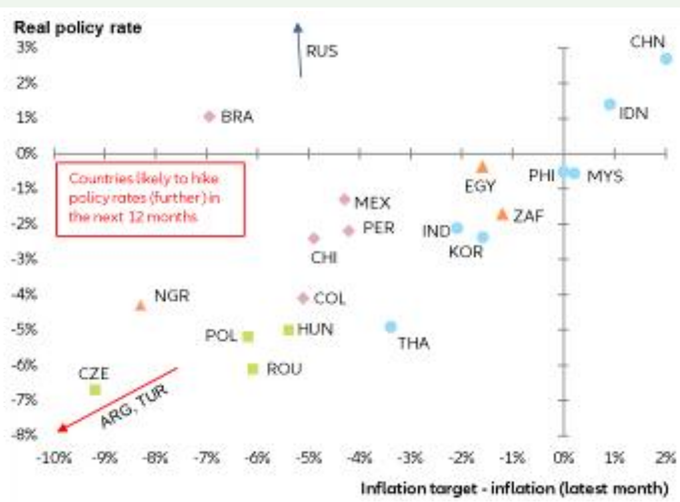
Figure: 12: EM vulnerabilities to the war in Ukraine

Export channel		Import channel		Energy and commodities channel						Current account	
Exports of goods to Russia (% of country's GDP)		Imports of goods from Russia (% of country's GDP)		Natural gas imports from Russia (% of country's total primary energy usage)		Russian energy, metals and agrifood inputs used in countries' output (% of GDP)		Net exports in energy, metals and agrifood (% of GDP), bottom 10 countries		Current account deficit (% of GDP), major EMs	
Belarus	21.8	Moldova	4.4	Hungary	36.0	Bulgaria	8.9	Tunisia	-11.9	Algeria	-10.9
Lithuania	7.8	Georgia	2.5	Czechia	19.8	Lithuania	5.2	Morocco	-8.8	Romania	-7.1
Latvia	6.3	Belarus	2.3	Romania	13.7	Hungary	2.3	South Korea	-6.6	Colombia	-5.7
Armenia	5.4	Libya	1.5	Poland	10.6	Poland	1.9	Viet Nam	-6.4	Kenya	-5.5
Kyrgyzstan	3.1	Sudan	1.0	Latvia	0.3	Latvia	1.5	Taiwan	-6.3	Tunisia	-5.5
Estonia	3.0	Azerbaijan	1.0	Slovakia	0.2	Kazakhstan	1.3	Slovakia	-6.2	Egypt	-5.1
Kazakhstan	2.9	Armenia	1.0	Lithuania	0.1	Turkey	1.3	Slovenia	-6.1	Chile	-3.5
Georgia	2.8	Bulgaria	1.0	Bulgaria	0.1	Estonia	1.1	Croatia	-6.1	Turkey	-3.0
Uzbekistan	2.0	Hungary	1.0	Turkey	0.1	Romania	0.8	Philippines	-6.1	Peru	-2.8
Slovenia	1.8	Lebanon	0.9	Estonia	0.0	Morocco	0.6	Panama	-5.9	Thailand	-2.2

Financial channel						Social risk		Policy room to maneuver			
Stock of FDI in country by Russia (% of country's GDP)		Currency depreciation (LCU vs EUR, % YTD), major EMs		Sovereign bonds: change in spread YTD (bp), major EMs		Imports of food and fuel (% of country's GDP)		Public debt sustainability risk score (0 = high risk; 100 = low risk)		Real policy interest rate (%), major EMs	
Belarus	6.6	Russia	-41.9	Russia	7526	Cape Verde	18.5	Egypt	11.0	Turkey	-40.7
Latvia	5.1	Belarus	-19.9	Ukraine	4701	Mauritania	17.9	Ghana	15.5	Argentina	-8.2
Tajikistan	4.8	Kazakhstan	-13.8	Argentina	1872	Belarus	17.6	Jordan	19.9	Czechia	-6.7
Moldova	4.5	Turkey	-6.5	Egypt	848	Belize	16.9	Tunisia	20.4	Romania	-6.1
Bulgaria	4.2	Ukraine	-5.4	Nigeria	658	Tajikistan	16.2	Mozambique	21.2	Poland	-6.0
Serbia	3.7	Poland	-4.3	Kenya	643	Maldives	16.1	Malawi	21.6	Algeria	-5.4
Belize	3.4	Hungary	-3.4	Turkey	625	Honduras	15.7	El Salvador	25.2	Hungary	-5.0
Dominica	3.4	Argentina	-2.2	Romania	378	Mozambique	15.3	Costa Rica	25.3	Thailand	-4.9
Bosnia & H.	2.6	Czechia	-1.1	Colombia	350	Jordan	13.0	Mauritius	25.8	Nigeria	-4.2
Kazakhstan	2.5	Romania	0.0	South Africa	307	Lithuania	12.3	Turkey	29.4	Colombia	-4.1

Sources: Refinitiv, Allianz Research

Figure: 13: Real policy interest rates



Sources: Refinitiv, Allianz Research

EM debt sustainability concerns will continue to increase. The start of the war caused a sell-off across many emerging financial markets. If risk aversion continues and the US Fed sticks to its planned interest rate hikes over 2022-2023 – as it appears for now – the risks of a taper tantrum (which we assessed to be moderate before the war) and especially to debt sustainability in EMs and developing economies are likely to rise, given the slower economic recovery, tightening international financing conditions and rising geopolitical tensions. While net commodity exporters (e.g GCC states, Colombia, Bolivia, Ecuador, Brazil) will be shielded, several factors will increase the risk of refinancing and debt distress for sovereigns. In 2022, widening budget deficits – due to increased subsidies and transfers to mitigate the impact of higher energy and food prices – will increase public debt. Moreover, higher inflation will weigh on the recovery after already sluggish growth in many markets in 2021. Abrupt currency depreciations (as a byproduct of widening current account imbalances), investors' flight to safety and higher risk premia will increase sovereign debt vulnerabilities. We identify several African countries (Tunisia, Egypt, Ghana, Mozambique, Mauritius) as well as Jordan, El Salvador and Costa Rica as hotspots, in addition to countries that are already in a situation of (quasi) default such as Sri Lanka, Bahrain, Lebanon, Suriname, Zambia, Pakistan and Argentina (see Table 5). Note that public debt sustainability risk in Turkey has also increased significantly since mid-2021, mainly because of the sharp TRY depreciation that has made the repayment of sovereign FX debt more difficult, as well as fiscal measures to compensate the population for losses from the currency slump. For EMs and developing economies in general, the substantial increase in (short-term) government debt held by domestic banks since 2020 means that sovereign debt distress could easily spread to banks and the other parts of domestic economy by a credit crunch. Finally, with the G20 debt relief initiative (DSSI) having expired at end-2021, high-risk countries such as Mauritania, Zambia and Angola will have to resume debt service payments this year. Meanwhile, Ukraine and Russia are highly likely to default as a result of the war and there is a moderate contagion risk for other CIS markets (for example Belarus and Kazakhstan). However, contagion risk for other EM sovereigns remains moderate for now, unless a large EM (such as Turkey or Egypt) experiences a sudden stop.

Table 5: Public Debt Sustainability Risk Score (25 most vulnerable EMs, out of 101 markets scored, as of March 2022)

Rank	Country (from high risk to low risk)	**Public Debt Sustainability Risk Score (0 = high risk; 100 = low risk)**	Total Public Debt (% of GDP)	Covid-19 Debt Shock (increase in public debt-to-GDP ratio)	Foreign Exchange-denominated Public Debt (% of total public debt)	Maturing Public Debt (% of GDP)	Fiscal Balance (% of GDP)	Interest Payments (% of fiscal revenues)	Effective Interest Rate (interest payments in % of public debt at the end of previous year)	Interest Rate - Growth Differential (%)
			max(2021;2022)	2019 -> 2021	2021	2022-2023	2021-2022	2022	2022	2016-2020
1	Sri Lanka	**9.3**	0.0	8.8	33.0	27.0	0.0	0.0	5.4	0.0
2	Egypt	**11.0**	12.3	52.4	23.2	0.0	0.0	0.0	0.0	0.0
3	Bahrain	**11.2**	0.0	0.0	0.0	0.0	0.0	0.0	47.3	42.3
4	Lebanon	**14.4**	0.0	84.0	0.0	0.0	31.4	0.0	0.0	0.0
5	Suriname	**15.0**	0.0	0.0	72.6	0.0	0.0	0.0	47.7	0.0
6	Ghana	**15.5**	21.6	0.0	0.0	64.1	0.0	0.0	0.0	37.9
7	Zambia	**16.1**	0.0	75.8	0.0	37.0	0.0	0.0	15.7	0.0
8	Jordan	**19.9**	13.0	20.4	0.0	16.2	0.0	26.6	41.1	41.6
9	Tunisia	**20.4**	10.4	0.0	0.0	66.3	0.0	41.3	45.1	0.0
10	Pakistan	**21.2**	23.7	100.0	1.8	44.2	0.0	0.0	0.0	0.0
11	Mozambique	**21.2**	0.0	0.0	0.0	100.0	0.0	14.2	48.1	7.6
12	Malawi	**21.6**	49.5	6.4	13.1	48.6	0.0	0.0	0.0	55.6
13	Argentina	**23.1**	2.9	48.0	0.0	38.3	0.0	58.8	37.1	0.0
14	El Salvador	**25.2**	22.2	13.7	0.0	100.0	0.0	21.5	28.0	16.6
15	Costa Rica	**25.3**	43.3	22.0	76.8	34.3	24.3	0.0	0.0	1.6
16	Mauritius	**25.8**	0.0	0.0	97.5	0.0	0.0	38.5	59.5	10.7
17	Trinidad and Tobago	**27.3**	39.2	0.0	43.8	100.0	0.0	24.5	10.6	0.0
18	Brazil	**28.0**	8.5	64.2	100.0	50.8	0.0	0.0	0.0	0.0
19	Yemen	**28.3**	11.2	13.6	13.8	100.0	0.0	0.0	88.1	0.0
20	Ukraine	**29.0**	26.7	9.3	3.8	64.5	5.7	22.1	0.0	100.0
21	Turkey	**29.4**	75.8	21.8	0.0	80.6	0.0	57.3	0.0	0.0
22	Panama	**29.6**	50.0	0.0	0.0	73.1	0.0	52.3	49.6	11.8
23	Kenya	**29.7**	42.6	28.3	1.7	76.1	0.0	0.0	3.0	85.6
24	South Africa	**30.0**	39.5	16.5	100.0	71.0	0.0	13.0	0.0	0.0
25	India	**30.6**	14.0	0.0	100.0	81.1	0.0	0.0	5.0	45.1

Source: Allianz Research

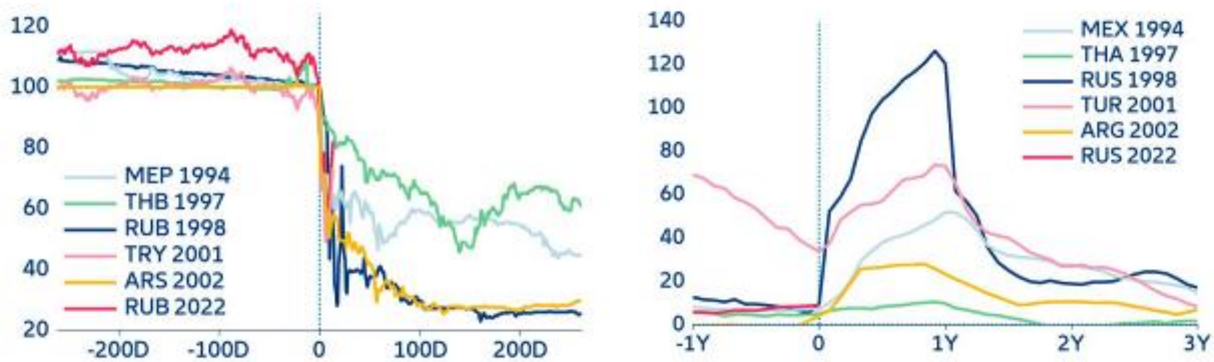
Note: To make the underlying data comparable across indicators, each of them was rescaled from 0 to 100, with 0 denoting the highest risk and 100 the lowest. Then the PDSRS was calculated as the average of the indicators, thus also ranging between 0 and 100.

Box 2: Current developments in Russia

The economic landscape has changed substantially following Russia's invasion of Ukraine on 24 February. The unprecedented sanctions have hit the Russian economy hard and paralyzed the financial system. Many foreign companies have halted production in Russia, which has already led to supply-chain disruptions, declining output and shrinking external trade. The Russian government will probably default on its debt repayments and many corporates will face insolvencies.

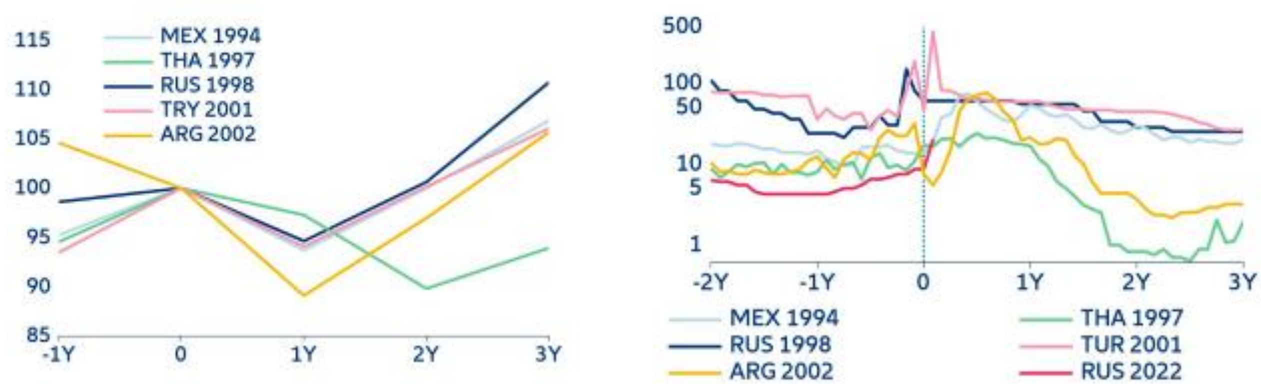
The Russian ruble has been the most salient causality. Similar crises in the past suggest that a sharp FX depreciation has long-lasting economic consequences, usually followed by tighter, inflation-fighting monetary policy, which often triggers recessions. As of today, all indications are that the Russian economy will experience the same scenario as sanctions limit policy space (in absence of external financial support (e.g. from the IMF).

Figure 14: Representation of some of the sharpest currency depreciations in the last 30 years (left) and how they shaped inflation (right).



Sources: Refinitiv, Allianz Research. Reference date equals the day prior to the sharpest fall in FX

Figure 15: Representation of the real GDP in the years around the FX event (left) and the monetary policy response (right, log scale).



Sources: Refinitiv, Allianz Research. Note: reference year/month corresponds to the year/month prior to the sharpest fall in FX

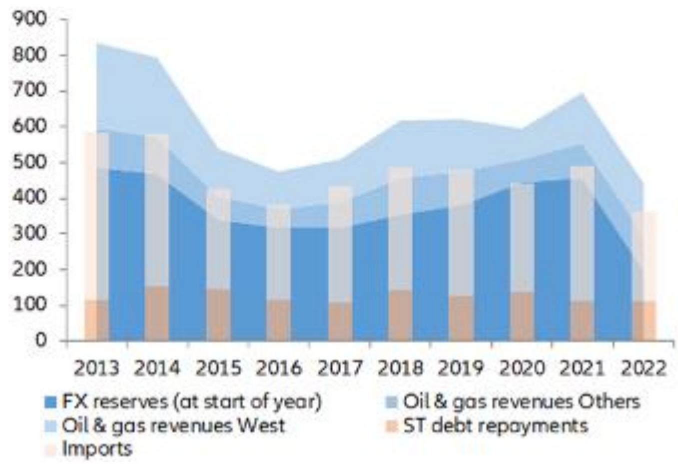
In our baseline "conflict escalation" scenario, we assume that the current financial sanctions will be maintained for longer and perhaps extended. However, we believe that a large-scale trade embargo against Russia is unlikely, given the EU's higher vulnerability, at least in the short term. We also do not expect Russia to cut off gas supply to the EU as this would mean a sharp reduction in the country's export and fiscal revenues, though this cannot be excluded for a few months, given the increased room to maneuver over the past years (including frontloading of public debt financing and increased FX reserves). And while approximately two thirds of the central bank's FX reserves (excluding gold) are currently frozen, the remainder (reserves in CNY and other currencies) plus monthly oil and gas revenues will keep the central bank liquid in this scenario. Nonetheless, Russia's economy will face significant adverse effects from the financial sanctions. The sharp depreciation of the RUB (-30% YTD) will cause inflation to surge to a projected 28% in 2022 and 20% in 2023, resulting in substantial monetary tightening and a strong decline in consumer and capital spending. Real GDP is forecast to contract by -8% in 2022 and -3% in 2023, which compares to forecasts of +3% and +2.5%, respectively, prior to the conflict escalation. The financing situation of Russian corporates and banks will also suffer, increasing non-payment risks significantly.

In our downside "black-out" scenario, we would expect that oil & gas exports from Russia to the West will be halted for a long time, either by a full-scale Western trade embargo or by Russia cutting off supply. And because a full diversion of Russian exports away from Europe to China seems highly unlikely in the short to medium run, for scale and operational reasons, the adverse effects on the Russian economy would be even harsher than in our baseline scenario. Real GDP would contract by around -16% in 2022 and -6% in 2023 and inflation would surge to 40% this year and 25% next year. Yet, the still liquid part of the central bank's FX reserves as well as FX income from exports to non-sanctioning countries will provide the Russian economy a lifeline for at least 12 months, according to our estimates.

Capital market implications - equities and corporate debt

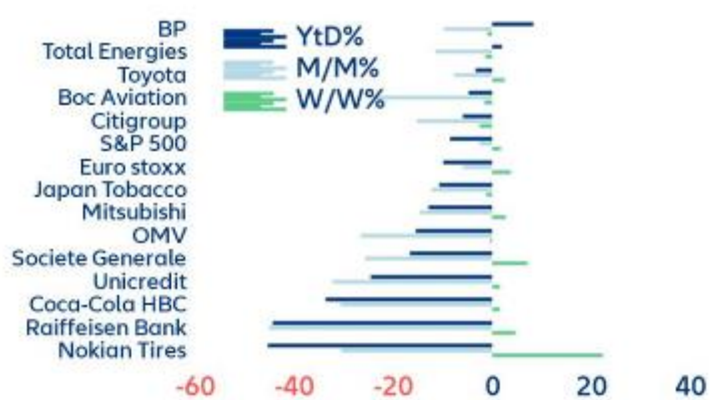
The Russian stock market remained closed for several days, although the depositary receipts in main financial hubs – or the performance of stocks with tight links to the country – have provided early signals of the appetite for Russian assets. The longer the conflict lasts, or the more intense it becomes, the harder it will be for foreigners to justify their exposure and the higher the likelihood that they are obliged to get rid of any exposure before being subject to sanctions. Even a ceasefire and relaxation in the sanctions would not bring back much of the capital that has fled: although companies would still manage the same amount of natural resources, the reputational loss and the awareness of the risk of Russian-dependency will have long-lasting damage on their value in the eyes of Western companies. In the event of a black-out scenario, which basically would perpetuate and worsen the current circumstances, one of their ways out would be an approximation to Chinese markets, although this will take time and it is not exempt of significant risks. When it comes to corporates there are two main items of concern: first, when companies will not be able to continue paying their obligations denominated in foreign currencies, especially with the Western sanctions on one side and the capital controls on the other. Second, how much appetite foreign investors will have to engage in news investments in Russia as the legal environment is set to be much harsher – from both sides – than it was two months ago.

Figure 16: Russia: FX reserves and income vs. FX needs (in USD)



Source: Allianz Research

Figure 17: Russia: corporate default risk



Sources: Bloomberg, Refinitiv, Allianz Research

The Emerging Europe region is caught between a rock and a hard place. The economic impact of the war will be felt mostly in Ukraine and Russia, which will both experience sharp recessions in 2022-2023. All countries in the region have significant trade relations with Russia and most of them also with Ukraine. Due to their historically close financial and economic ties to Russia or Ukraine, Central and Eastern European countries, most of them formerly part of the Soviet sphere of influence until the end of the Cold War, have been heavily affected. Some of them are highly dependent on trade with Russia and host Russian banks, which has resulted in increasing pressure on their currencies (Figure 18). In some of them, central banks have raised their policy rates to help defend the FX rate (e.g. Poland and Czechia).

Figure 18: FX deterioration (left) and sovereign spreads (OAS) of EUR-denominated bonds widening (right) of selected Eastern European countries

Sources: Refinitiv, Allianz Research

Moreover, all countries (including Turkey) in the region are large energy importers and thus highly vulnerable to the current global oil & gas price shocks. These dependencies combined with the regional proximity to the conflict countries have led to a deterioration of investor sentiment towards the whole region, including the CEE-EU-11, and further aggravated the already poor sentiment towards Turkey because of its homemade financial crisis. The currencies of CIS economies have taken a hit since 23 February, as well as those of Poland, Czechia and Hungary, which have depreciated markedly against the EUR. Other countries (e.g. Romania, Croatia, Serbia) have intervened in the FX markets to keep their currencies stable for now. The immediate impact of higher energy prices and falling currencies will be additional upward pressures on already elevated headline inflation across the region. We now expect annual consumer price inflation in the CEE-EU-11 to peak in Q2 2022 (instead of Q1 previously) at the earliest, and to average 8% in 2022 (compared to 5% at end-2021) and 4% in 2023. As a consequence, central banks in the region will need to hike interest rates more substantially in 2022 than assumed before – note that real policy rates are still very negative in the region – in order to rein in upward currency and price pressures, which will dent domestic demand. Overall, reduced exports to Russia and Ukraine, lower imports from Russia and Ukraine including supply-chain disruptions, as well as weaker domestic demand will adversely affect regional economic output. Romania needs to be watched because of its already weak current account position, which is likely to worsen further. We have revised our forecast of real GDP growth in the CEE-EU-11 to +3.47% in 2022 (compared to 4.1% at end-2021) and +2.9% in 2023 (+3.9%). In Emerging Europe as a whole (including Russia and Ukraine), we project a recession of -1.6% in 2022 (+3.2% previously) and modest growth of +0.7% in 2023 (+3.4% previously).

The adverse effects of the invasion of Ukraine on the rest of the Emerging Europe region will be much harder in our adverse scenario where trade relations between Russia and Europe are also largely frozen. In this scenario, we expect average inflation of 9% in 2022 and 6% in 2023 in the CEE-EU-11. Real GDP growth would slow to +2.7% in 2022, followed by a recession of -0.5% in 2023. For Emerging Europe as a whole we would forecast recessions of -5.3% in 2022 and -2.6% in 2023.

We expect real GDP growth for **Emerging Asia** excluding China to reach +7.1% in 2022 and +6.7% in 2023 (after +8.3% in 2021 and –2.9% in 2020). This implies a very slightly upwards revision for 2022 on the basis of a stronger-than-expected carryover effect from the end of 2021, a softer-than-expected negative impact of the spread of the omicron variant in most economies (with Hong Kong being a clear exception) and manageable exposure to the crisis caused by the invasion of Ukraine. Several economies in South and Southeast Asia should benefit from a catch-up effect in 2022 after weathering the pandemic with comparatively more difficulty in 2020-2021. As net exporters of commodities (taking into account the overall net trade balance for energy, metals and agrifood), Indonesia and Malaysia are likely to benefit from the environment of higher commodities prices resulting from the invasion of Ukraine, while it could be a headwind for Pakistan, Vietnam, the Philippines, India and Thailand (with several also still constrained by the absence of normalization in tourism receipts). Net importers of commodities will also see larger inflationary pressures, with the emerging Asia region overall seeing upwards revisions ranging between +0.1pp and +0.6pp in 2022 inflation forecasts. With a delay compared to other parts of the region and other emerging economies, and provided the economic recovery is on track, South and Southeast Asian central banks are likely to start normalizing monetary policies in the second half of 2022.

Latin America will continue to face several headwinds throughout the year. Many countries in the region have faced a significant inflationary outbreak since last year, a mix of a surge in commodity prices – notably food, an important component of the consumer basket in the region – and increased cost prices due to lingering supply shocks. Facing the balance of risks, namely "support weak growth vs control inflation", central banks in the region have made efforts to achieve price stability. In countries with hyperinflationary memories, price inflation can be quickly transmitted to inflationary expectations, hence controlling prices is paramount. Benchmark interest rates have already significantly increased in the largest economies and further hikes are expected during the year. Tighter financial conditions weigh further on economic growth, which has not yet recovered from the Covid-19 crisis.

Lower growth and higher interest rates also pose significant challenges in the fiscal front. As in advanced markets, several countries announced fiscal stimulus during the pandemic, raising debt significantly, and fiscal consolidation is therefore necessary. As a policy shift looms for major central banks, (towards less accommodation and/or rate hikes), emerging markets are highly exposed and should be prepared for potential economic turbulence. But the magnitude of the effects highly depends on economic fundamentals.

The current geopolitical scenario is adding fuel to the fire. The invasion of Ukraine is driving commodity prices to new highs, signaling that those inflationary pressures are far from cooling down any time soon. The outlook is somewhat more favorable for major oil & gas exporters such as Bolivia, Colombia and Ecuador. But net commodity-exporting countries such as Argentina, Brazil and Peru could also benefit from higher commodity prices. Note however that gains for Argentina should be limited due to export restrictions on agricultural products, notably beef, corn and wheat. Such measures put further price pressures on the global agriculture markets as Argentina is an important exporter of these goods. Food prices can also face additional pressure from fertilizers. Brazil, Argentina, Ecuador, Peru, Colombia and Costa Rica rely on Russia as an important supplier of fertilizers, meaning higher prices and risks of agricultural supply shortages, signaling further price pressures ahead. Net commodity importers, mainly located in Central America (e.g. Dominican Republic, El Savador) could see some pressures on the current account. Rising political risks in Mexico, due to increasing concerns of violation of the rule of law, and in Brazil, due to the presidential elections in October, are also sources of instability in the year. In this context, we significantly revise our growth and inflation prospects for the region. In our baseline scenario, we expect GDP to reach +1.7% in 2022 (-0.7 pp) and +2% in 2023 (-0.6pp), and inflation to reach 10.6% in 2022 (+1.3pp) and 6.8% (+2pp) in 2023.

In the **Middle East and Africa**, commodity exporters, particularly the GCC economies and other large oil & gas producers such as Algeria, Nigeria and Angola, will benefit from higher global prices. This will provide some of them with more fiscal leeway to support the hitherto modest recovery from the Covid-19 crisis. But net energy and food importers in the region will suffer. Governments might try to protect households from the impact of higher costs for food and energy through increased subsidies. This could deteriorate already weak fiscal positions, for example in Jordan and North Africa. The latter could also be affected by declining tourism if higher fuel prices hit global travelling. Overall, we forecast real GDP in the **Middle East** to grow by around +4.5% in 2022 and +2.7% in 2023, irrespective of the scenario as higher oil and gas revenues in the downside scenario will enable GCC governments to compensate residents for increased food prices. In **Africa**, economic growth is projected at +3.4% in 2022 and +2.7% in 2023 in our baseline scenario, and at +2.5% and +2.3%, respectively, in our downside scenario. High oil and commodity prices will support the fiscal and external balances of net oil exporters such as Angola, Libya, Congo, Algeria and Nigeria as well as commodity producers (e.g. South Africa, Ghana, Zambia). Countries highly dependent on cereal imports from Ukraine and Russia, such as Egypt, Morocco, Tunisia, Senegal and Tanzania, will face increasing risk of food insecurity and social unrest. Domestic agricultural activity is likely to be hampered in Egypt, Benin, Morocco, Ghana and Senegal due to rising energy and fertilizer costs and potential supply shortages. After two years of Covid-19, tourism revenues will shrink again in Egypt, Tunisia, Kenya and Tanzania.

CAPITAL MARKETS: SHELL-SHOCKED

Table 6: Capital markets performance

	Unit	Value as of 16/03/2021	Change since 23.02.2022 (UA - RU)	Change since 31.12.2021	Total Return since 31.12.2021
EMU					
Government Debt					
Policy rate (ECB deposit rate)	%	-0.50	0	0	
10y yield sovereign (Bunds)	%	0.40	17	58	-5.0%
10y swap rate	%	1.03	17	75	-5.0%
Italy 10y sovereign spread	bps	151	-21	14	-5.7%
France 10y sovereign spread	bps	46	-5	9	-4.6%
Spain 10y sovereign spread	bps	95	-10	17	-6.0%
Corporate Debt					
Investment grade credit spreads	bps	152	19	54	-5.2%
High-yield credit spreads	bps	458	48	127	-6.0%
Equity					
Eurostoxx	€ / %	431	-2.1%	-9.9%	-9.7%
US					
Government Debt					
Policy rate (mid-rate)	%	0.38	25	25	
10y yield sovereign (Treasuries)	%	2.19	21	69	-5.5%
Corporate Debt					
Investment grade credit spreads	bps	146	22	48	-8.5%
High-yield credit spreads	bps	396	24	86	-5.7%
Equity					
S&P 500	$ / %	4358	3.1%	-8.6%	-8.3%
UK					
Government Debt					
Policy rate	%	0.50	0	25	
10y yield sovereign	%	1.63	15	66	-5.6%
Corporate Debt					
Investment grade credit spreads	bps	160	17	45	-8.2%
High-yield credit spreads	bps	477	41	87	-4.4%
Equity					
FTSE 100	£ / %	7292	-2.8%	-1.3%	-1.3%
Emerging Markets					
Government Debt					
Hard currency spread (vs USD)	bps	402	59	107	-11.2%
Local currency yield	%	6.24	22	54	-9.1%
Equity					
MSCI EM ($)	$ / %	2626	-10.3%	-12.0%	-12.0%

Sources: Allianz Research

Table 7: Capital market scenarios

year-end figures	Last value	Unit		Conflict Escalation		Black-out	
EMU			2021	2022f	2023f	2022f	2023f
Government Debt							
Policy rate (ECB deposit rate)	-0.5	%	-0.5	-0.5	0.0	-0.5	-0.5
10y yield (Bunds)	0.40	%	-0.18	0.15	0.50	-0.35	-0.10
10y swap rate	1.03	%	0.28	0.55	0.80	0.25	0.4
Italy 10y sovereign spread	151	bps	136	160	175	135	150
France 10y sovereign spread	46	bps	37	40	45	35	40
Spain 10y sovereign spread	95	bps	77	80	90	70	85
Corporate Debt							
Investment grade credit spreads	152	bps	98	120	125	180	165
High-yield credit spreads	458	bps	331	400	420	650	525
Equity							
Eurostoxx (total return p.a.)	-9.7	%	20	3	6	-13	4
US			2021	2022f	2023f	2022f	2023f
Government Debt							
Policy rate (mid-rate)	0.375	%	0.125	1.625	2.625	0.125	0.125
10y yield (Treasuries)	2.187	%	1.50	1.90	2.30	1.20	1.50
Corporate Debt							
Investment grade credit spreads	146	bps	98	115	120	175	160
High-yield credit spreads	396	bps	310	390	415	600	500
Equity							
S&P 500 (total return p.a.)	-8.3	%	26.9	4	7	-11	5
UK			2021	2022f	2023f	2022f	2023f
Government Debt							
Policy rate	0.5	%	0.25	1.00	1.50	0.75	0.50
10y yield sovereign	1.63	%	0.97	1.20	1.50	2.20	1.50
Corporate Debt							
Investment grade credit spreads	160	bps	115	130	140	190	175
High-yield credit spreads	477	bps	390	450	475	675	550
Equity							
FTSE 100 (total return p.a.)	-1.3	%	14.3	5	8	-9	6
Emerging Markets			2021	2022f	2023f	2022f	2023f
Government Debt							
Hard currency spread (vs USD)	402	bps	295	360	375	470	430
Local currency yield	6.2	%	5.7	6.7	6.5	8.2	7.0
Equity							
MSCI EM: total return p.a. in USD	-12.0	%	-4.6	0	4	-14	3

Source: Allianz Research

The invasion of Ukraine has exacerbated downside pressures in capital markets but has yet to trigger dislocations commonly associated with financial crises. Since Q4 2021, markets have already experienced a significant deterioration in sentiment. Markets repositioned for a faster-than-expected monetary policy normalization, which brought an end to the post-Covid-19 bull run. This initial repositioning left investment grade (IG) corporate credit ~25-30bps wider and equity markets 5% lower compared to their respective 2021 maximum (Figure 19). At this point, markets had bought into the "reflation narrative", with a higher commodity-originated inflation push providing a mild, but still positive, market impulse. However, this has suddenly changed with Russia's invasion of Ukraine, which triggered an abrupt market repositioning and rising expectations of stagflation.

The broad-based risk repricing has been felt across all major asset classes, with equities heavily underperforming. The peak-to-date performance of equities has been similar to that experienced during other historical market sell-offs. Nonetheless, the key to a structurally bearish rotation would require the current negative performance to persist until next year so it is still too early to deem the current market correction as a bellwether of financial crisis (Figure 18). At the same, time aggregated market sentiment has rapidly shifted, with market participants turning as bearish as were at the onset of the Covid-19 crisis and during the global financial crisis (GFC) (Figure 20).

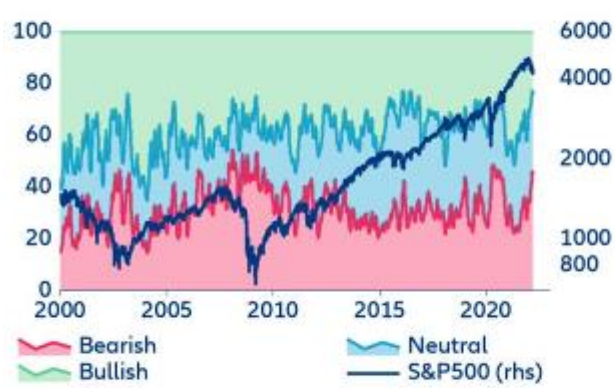
The equity market sell-off has been harsher in the Eurozone. The Eurostoxx has lost as much as -15.4% ytd while the US and the UK have corrected by -10.4% and -3%, respectively. This market bearishness coincides with the largest outflows from European Equity Funds and ETFs (~2bn) since late 2021. In addition, most other risky assets have suffered extensive outflows since the beginning of the year (Figure 21).

Figure 19: VIX vs daily Geopolitical Index & commodities vs equities (100 = Dec 2020).

Sources: Refinitiv, Allianz Research

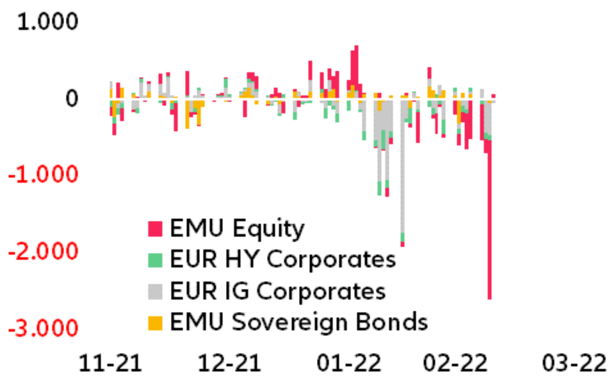
Note: Geopolitical Risk Index: Caldara, Dario and Matteo Iacoviello, Board of Governors of the Federal Reserve

Figure 20: US equity market performance and market sentiment during crises



Sources: Refinitiv, American Association of Individual Investors, Allianz Research

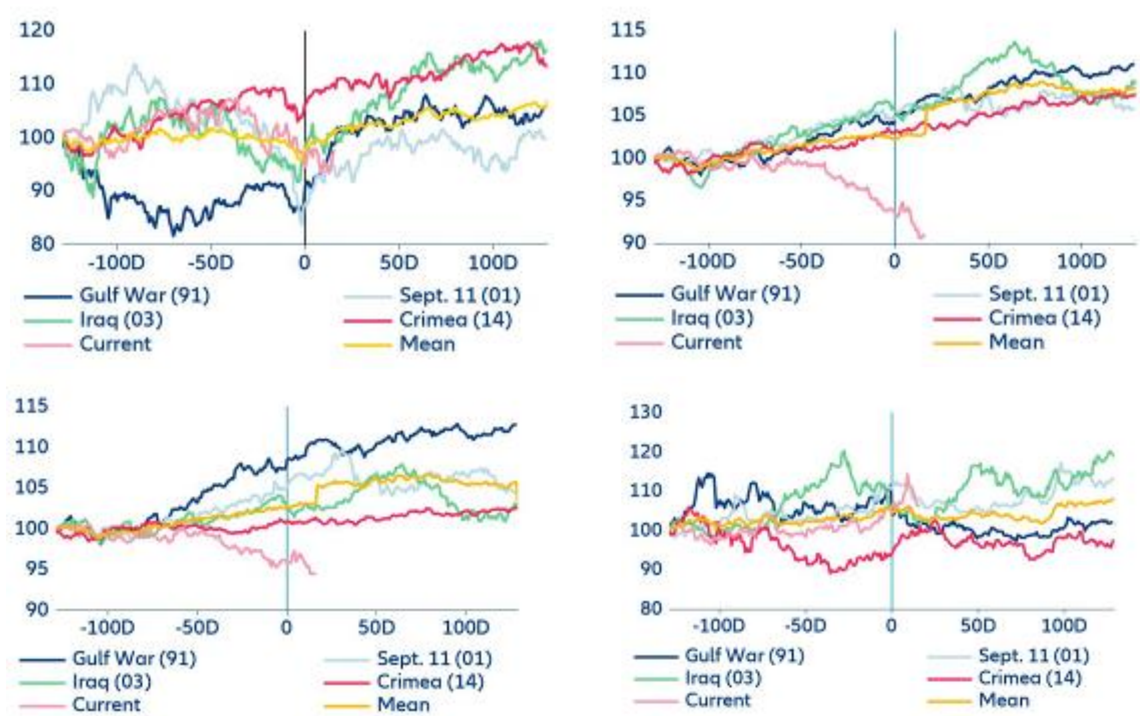
Figure 21: European Fund and ETF Flows (EUR mn)



Sources: Refinitiv, Allianz Research

Historically, publicly-traded assets do not underperform during times of war or geopolitical conflict. Over the last 30 years, after each crisis, all asset classes recorded a mildly positive return performance over a three-month period. However, the current market correction at the time of conflict seems far more abrupt, especially for risky assets, suggesting that this time things might be different as the stagflationary environment creates a double-edged sword for risky assets (Figure 22).

Figure 22: Equities, corporate, sovereign and gold (rebased to 100)



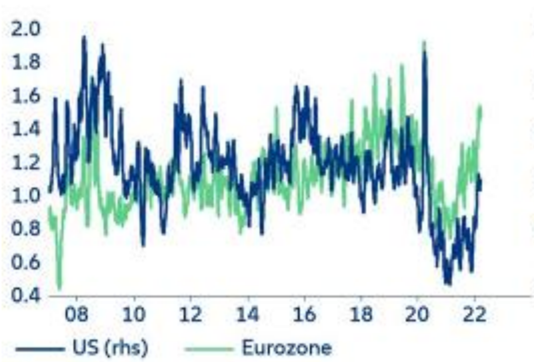
Sources: Refinitiv, Allianz Research

High uncertainty has also impacted market liquidity and hedging strategies. Equity bid-ask spreads have widened and market participants have increased their put protection, as depicted by the rapid increase in the put-to-call ratios (Figure 23). This increase in aggregated hedging has been far more pronounced in Europe than in the US.

Inflation, growth, stability: the central banks' trilemma! Over the next few months, central banks will have to contend with elevated inflation expectations and slowing growth due to the negative supply shocks amplified by the Ukraine war while safeguarding financial stability in an environment of high volatility. Markets clearly expect that central banks will prioritize inflation over growth in the short term. USD and EUR money markets seem to have positioned for a close end of the escalation phase and have returned to their pre-crisis short-term monetary policy outlook. Within the next 12 months, nine hikes of 10bps are again priced in for the Eurozone and seven hikes of 25bps for the US.

Rising growth concerns will make for a shallow hiking cycle. The forward term structure remains heavily frontloaded, with the entire hiking cycle being priced in within the next 18 months. We see two main reasons for this: (i) a weakening upside spiral between oil prices and inflation expectations (topping out of geopolitical risk premium and increasing supply substitution) and (ii) rising recession fears as higher rates will affect already slowing growth. In the US, the discount of growth expectations is already visible in the shape of the yield curve: money market forwards indicate a significant probability of a first rate cut as early as Q4 2023 and the yield curve is close to inversion (2y10y) while the 1y forward curve already inverted. The inversion of the ratio of the US curve slope to the oil price underlines the recession risk as over the last decades, such an inversion was always followed by a recession in the next 9-12 months (Figure 24).

Figure 23: Put/call ratio and gold vs equities



Source: Refinitiv, Allianz Research.

Figure 24: Slope-oil ratio entering recession territory

Source: Refinitiv, Allianz Research.

Bond markets price a hard landing over the medium term. In terms of our scenarios, the short end of the curve is close to our baseline ("crisis escalation") scenario, with central banks tackling the inflation problem with rapid rate hikes. Limited upward movement at the longer end of the curve tells us that markets expect a hard landing of the US economy over the medium term, which is close to our black-out scenario. We expect little upside from the expected nominal short-term rates component, given the already ambitious market pricing and (re-)anchored inflation expectations, with 10y US Treasuries should settle around 2% at the end of the year (and 2.3% next year). From the risk component part (term premium), the reduction in inflation risk premium and safe haven demand will compensate for the upside effect related to the change in the supply/demand dynamics due to quantitative tightening. However, if we switch to the adverse ("black-out") scenario, 10y US Treasuries would decline to 1.2% (and 1.5% next year) and 10y German Bund to -0.35% (and -0.1% next year). While inflationary pressure persists, monetary policy will be reversed as recession risks materialize. Given current market pricing, expected nominal short-term rates will be adjusted sharply downward. In this scenario, we would also see increased safe haven flows and reduced quantitative tightening, which results in a lower term premium (Figure 25).

Equity markets already started to underperform at the turn of the year. The hawkish shift by central banks and the subsequent repricing in long-term real yields triggered an underlying change in equity style performance. Growth companies underperformed their value counterparts on the expectation of higher interest rates and an accelerated quantitative tightening pace. However, this trend reversed at the onset of the Russian invasion of Ukraine as higher energy prices (together with concerns about shortages of important commodities and the impact of trade sanctions on supply chains) accelerated inflation expectations and increased recessionary fears. As of today, equity markets are deep in the red across geographies, with countries nearer to the conflict and more dependent to Russian imports and exports being hit the most. Additionally, and despite experiencing some sectoral differences, more than 80% of Eurozone stocks are currently trading below the 250-day moving average. In the case of the US, close to 65% of stocks are trading below their yearly average (Figure 26). Mainly due to the newly self-imposed commodity supply constraints, the only sector still trading in the positive over the year remains the energy sector, with utilities being close to turning green in the case of the US.

Figure 25: US and Eurozone 10y sovereign yield outlook (%)

Source: Refinitiv Datastream, Allianz Research.

Figure 26: EZ and US: stocks above the 250D moving average and sectoral performance (%)

Source: Refinitiv, Allianz Research.

Going forward, the decline in real yields should stabilize equity markets as long as the global economy does not end up in a full-fledged recessionary environment. This metric can be taken as an inverse proxy for forward equity valuations (Figure 27). In addition, equity markets tend to outperform in periods of rising interest rates, at least after 100 days from the start of the hiking cycle. We expect some equity market resilience throughout the year despite the current short-term volatility.

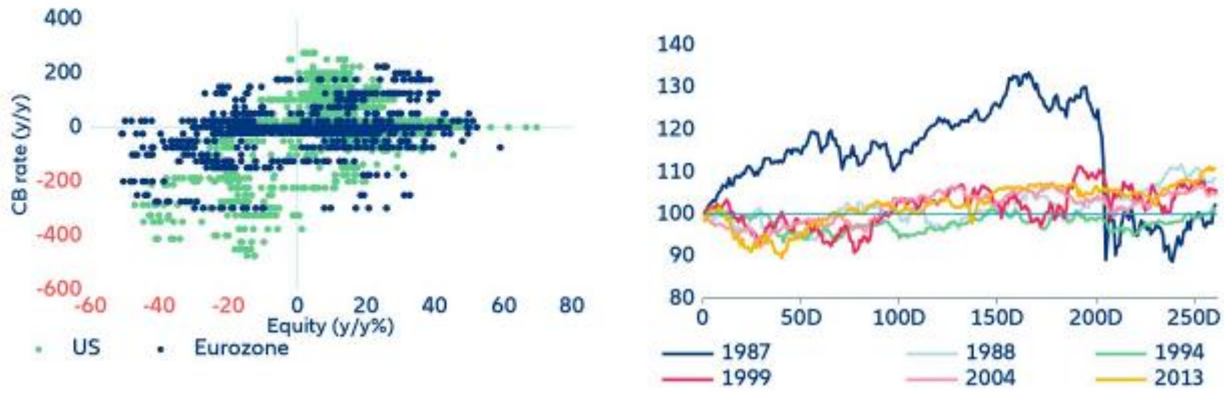
The effective balance between changes in the monetary stance and inflation expectations will be the key determinant of future returns. In other words, if central banks manage to normalize monetary policy without spooking money flows while inflation expectations remain somewhat elevated but declining, they would be creating a favorable environment for equity resilience. This is what we expect in our baseline scenario, with equity markets likely to finish the year with close to 2-5% in total return (Figure 29).

However, if the current recessionary worries materialize, we expect the monetary component of our decomposition framework, aided by a negative real yield pass-through effect, to outpace any short-term benefits of temporary higher inflation. This scenario would equity performance deep into the red this year.

Figure 27: 18m FWD PE vs real yields (%)

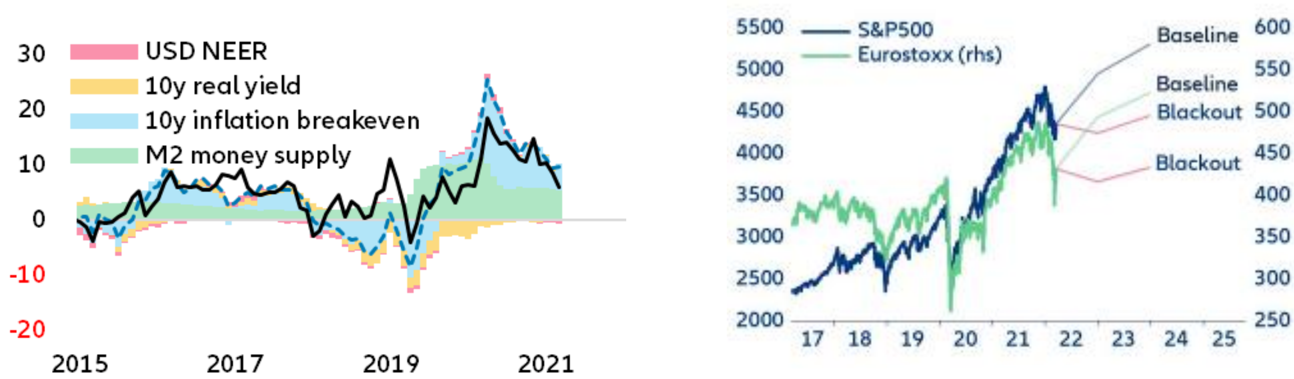
Source: Refinitiv, Allianz Research.

Figure 28: CB Rates vs EQ performance & US S&P500 performance after first rake hike (%)



Sources: Refinitiv, Allianz Research.

Figure 29: US Equity market decomposition and equity scenarios (%)



Sources: Refinitiv, IBES, Allianz Research.

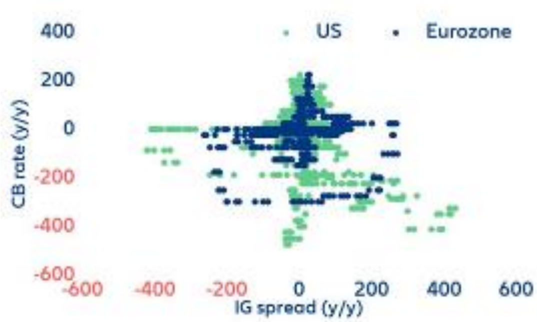
As in the case of equities, the rapid repricing of monetary policy expectations in late 2021 and early 2022 erases the implicit central bank policy anchor for corporate; this can be seen in the rapid repricing of +20bps for EUR and US investment grade credit spreads (Figure 30). This quick repricing has been exacerbated by the pass-through effect of increased equity volatility, due to Russia's military actions, to credit spreads.

Despite the currently high uncertainty around the economic and policy outlook, central banks' implicit put protection seems to have started working again, as seen in the renewed divergence of corporate credit performance from equities, especially after central bank policy meetings. In the case of the ECB in particular, the tone of each meeting sets the pace for a corporate-to-equity or an equity-to-corporate rotation, with the latest being a corporate rotation (Figure 31). Higher policy rates in Europe tend to be associated with a widening of investment grade corporate spreads. This can be observed in the relatively high concentration of observations in the first quadrant (increasing rates + widening spreads) of Figure 31 and the relative emptiness of the second quadrant (increasing rates + compressing spreads). Interestingly, the US corporate market does not exhibit the same pattern, with spread movements in hiking periods being equally distributed between the first and second quadrant.

Figure 30: Investment grade corporate spreads (bps)

Source: Refinitiv, Allianz Research.

Figure 31: Investment grade corporate spreads



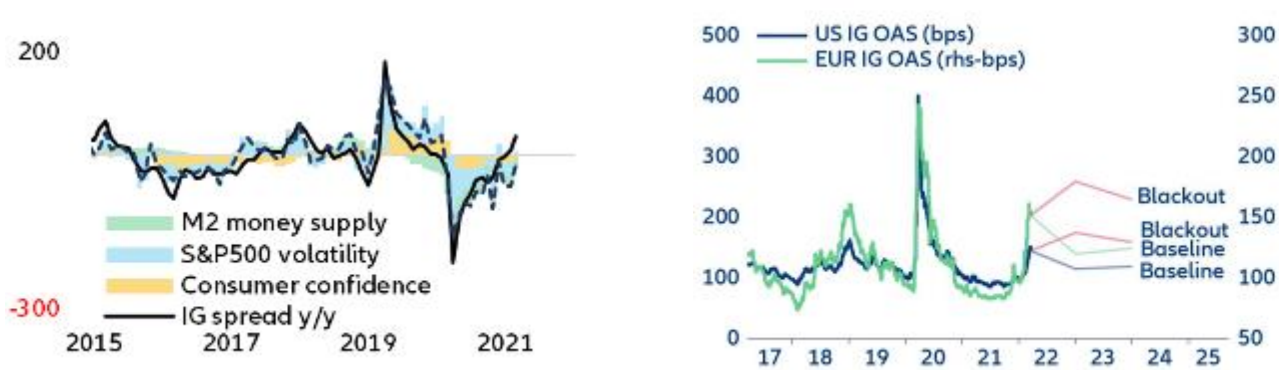
Source: Refinitiv, Allianz Research.

Using our decomposition framework as a base for future performance and as in the case for equity markets, the monetary aggregate component highly dependent on monetary and fiscal policy will remain the key determinant of corporate credit performance throughout the year. In this regard, the fine balance between policy moves and short-term equity volatility should manage to compensate for a deteriorating consumer confidence due to the economic headwinds keeping corporate spreads, especially investment grade on a leash (Figure 32).

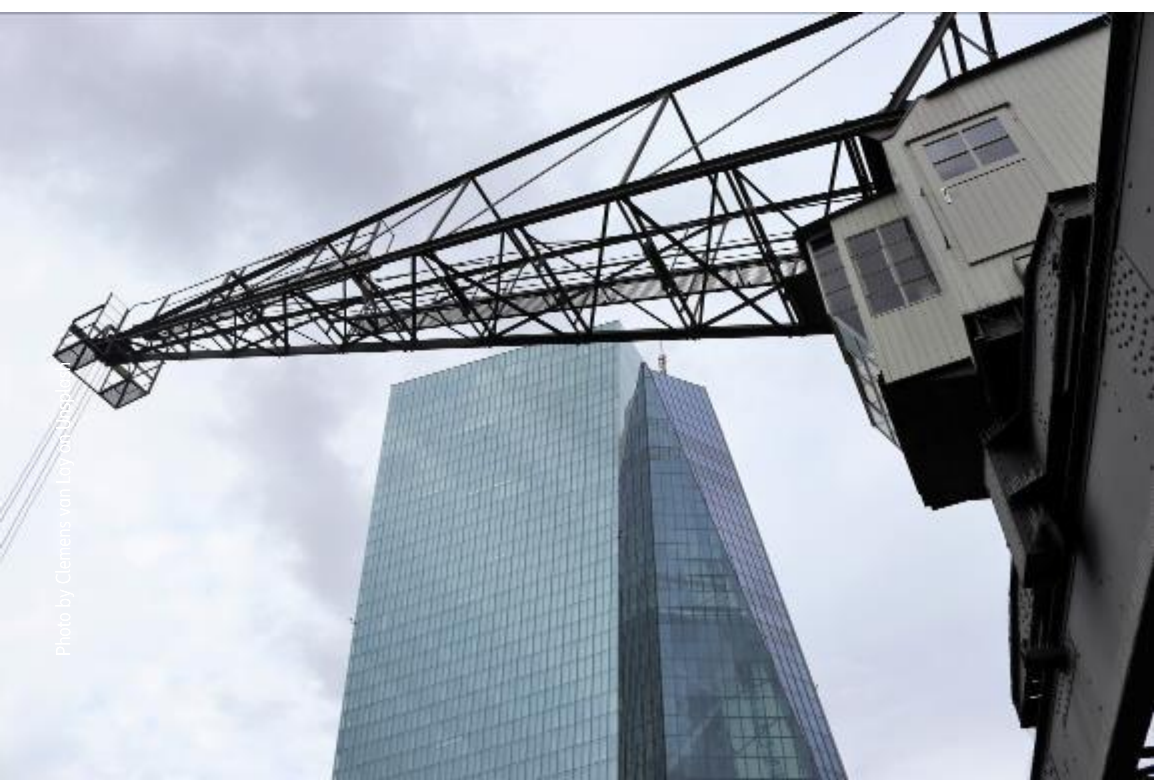
In our baseline scenario, the widening of corporate credit spreads is likely to slow and even revert as markets reprice the possibility of extended monetary and fiscal policy support. We expect investment grade corporate credit spreads to peak close to ~160bps but then decline to 120-130bps by the end of 2022. At the same time, we expect high-yield corporates spreads to briefly visit the ~470-480bps level, converging back to 400-420bps towards year end.

In the adverse scenario, we would expect corporate credit spreads to significantly widen, with spreads reaching 260bps and 670bps for investment grade and high yield, respectively, mainly driven by exacerbated equity volatility and deteriorating economic conditions (Figure 32).

Figure 32: US Corporate credit spread decomposition and corporate credit scenarios (bps)



Source: Refinitiv, Allianz Research.



Emerging markets

The effects of higher asset volatility in the main financial markets, together with tightening financial conditions, are also being felt in emerging market economies. Central banks seem to remain firmly on course towards significantly withdrawing monetary stimulus this year despite growth concerns. Although some form of tapering had already been priced in during the second half of 2021, the flight to safety has caused a significant decline of net capital flows into emerging markets. In fact, capital flows might reverse if the situation in Ukraine were to deteriorate further, similar to what happened at the onset of the Covid-19 crisis in early 2020. Although the Fed would try to soften the spillovers (e.g. via swap lines), episodes of scarce liquidity and stress could take place.

Higher inflation in advanced economies could spell trouble for capital flows to emerging markets. The widespread volatility, contagion fears and concerns about commodity shortages after Russia's invasion of Ukraine (including the sanctions on Russia) have increased inflation expectations, which could trigger increased outflows due to tighter financing conditions and a generalized flight to safety. In the case of an unexpected acceleration of tightening – or worse, a policy mistake – several emerging market countries, especially those with high debt levels, are vulnerable. In addition, there is a risk contagion even in absence of a financial crisis scenario. Regulation tends to be less robust in many emerging countries, which could alter the normal functioning of markets in some countries. If investors learn a tough lesson with the Russian investments, they may reduce their exposure to other risky emerging countries.

We have revised upward our forecasts for EM sovereign spreads, acknowledging that this will prove to be another bumpy year. Nonetheless, only in the case of the black-out scenario materializing will they will reach higher levels that the maximum they have already recorded during the year.[5] This is also reflected in our projection of local yields. The pressure on local yields will increase and countries will need to offer higher coupons or issuing other type of bonds (inflation linkers, FX-denominated).

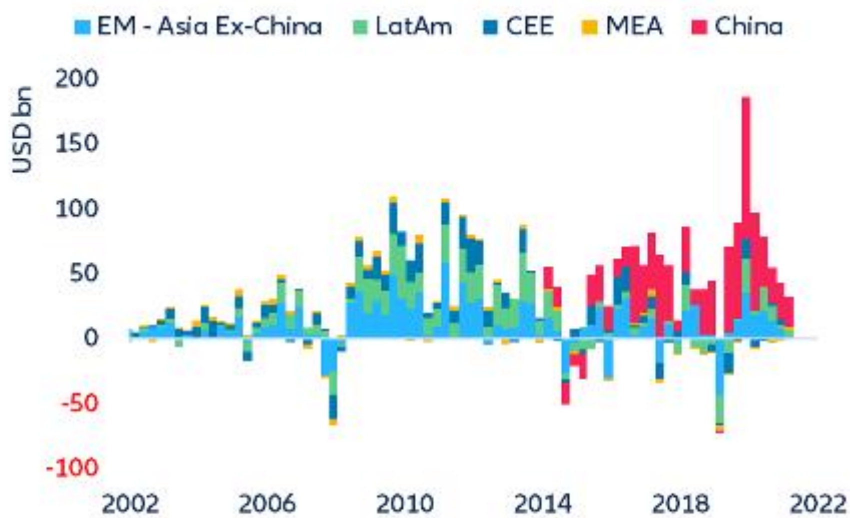
Figure 33: EM Scenarios for hard currency spreads (left) and local yields (right). Index levels.

Sources: Bloomberg, Allianz Research

5. *For this we refer to EMs as a group, there are specific countries for which the statement may not hold.*

Capital flows are likely to be very volatile this year, even as some vulnerable markets have not brought back all the investments that left in the first half of 2020 (Mexico, Russia, Turkey). In addition to the adverse spillover effects to Eastern Europe and Latin America mentioned earlier, Emerging Asia could also be affected via the financial channel. Despite a calmer bond market during 2021, the region is no stranger to pressure from higher interest rates. In relation to this, another key source of uncertainty will be whether the tensions in Chinese equities will also apply to sovereign bonds. In that sense some signs have already appeared as February was one of the worst months in terms of foreign holdings of Chinese treasuries (Figure 34). Nonetheless, the reasons are unclear as some EM portfolios could have preemptively sold some positions to cover possible Russian losses.

Figure 34: Quarterly capital flows from/to emerging markets, by region



Sources: IIF, Allianz Research

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OUR TEAM

Chief Economist of Allianz


Ludovic Subran
Chief Economist
ludovic.subran@allianz.com

Global Head Economic Research, Euler Hermes


Ana Boata
ana.boata@eulerhermes.com

Global Head Macroeconomic & Capital Markets Research, Allianz SE


Andreas Jobst
andreas.jobst@allianz.com

Global Head of Insurance, Wealth and Trends Research


Arne Holzhausen
arne.holzhausen@allianz.com

Macroeconomic Research


Selin Ozyurt
Senior Economist for France and Africa
selin.ozyurt@eulerhermes.com


Katharina Utermöhl
Senior Economist for Europe, DACH
katharina.utermoehl@allianz.com


Roberta Fortes
Economist Ibero-Latam
roberta.fortes@eulerhermes.com


Françoise Huang
Senior Economist for APAC & Trade
francoise.huang@eulerhermes.com


Manfred Stamer
Senior Economist for Middle East and Emerging Europe
manfred.stamer@eulerhermes.com


Dan North
Senior Economist for North America
dan.north@eulerhermes.com

Sector Research


Maxime Lemerle
Head Sector and Insolvency Research
maxime.lemerle@eulerhermes.com


Aurélien Duthoit
Sector Advisor for Retail, Electronics-related sectors, Textile and Household Equipment
aurelien.duthoit@eulerhermes.com


Ana Kuhanathan
Sector Advisor for Energy, Construction, Metals, Machinery, and Data Scientist
ana.kuhanathant@eulerhermes.com

Insurance, Wealth and Trends Research


Michaela Grimm
Senior Expert Demographics
michaela.grimm@allianz.com


Markus Zimmer
Senior Expert ESG
markus.zimmer@allianz.com


Kathrin Stoffel
Expert Insurance & Wealth
Kathrin.stoffel@allianz.com


Alexis Garatti, Senior Economist for ESG and Public Policy
alexis.garatti@eulerhermes.com


Patricia Pelayo Romero
Expert Insurance & ESG
patricia.pelayo-romero@allianz.com

Capital Markets Research


Eric Barthalon
Head of Capital Markets Research
eric.barthalon@allianz.com


Jordi Basco Carrera
Senior Investment Expert
jordi.basco_carrera@allianz.com


Patrick Krizan
Senior Economist for Italy and Greece, Fixed Income
patrick.krizan@allianz.com


Pablo Espinosa Uriel
Capital Markets Research Analyst
pablo.espinosa-uriel@allianz.com

Director of Publications: Ludovic Subran, Chief Economist
Allianz and Euler Hermes
Phone +49 89 3800 7859

Allianz Research
https://www.allianz.com/en/economic_research

Königinstraße 28 | 80802 Munich | Germany

allianz.research@allianz.com

allianz

@allianz

Euler Hermes Economic Research
http://www.eulerhermes.com/economic-research

1 Place des Saisons | 92048 Paris-La-Défense Cedex | France

research@eulerhermes.com

euler-hermes

@eulerhermes

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