



26 March 2024

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The 2024 soft landing is the trailer;
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Allianz Research

Soft landing: It's a wrap?

Global Economic Outlook 2024-25

Updated at end of Q1 2024

Executive Summary

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- **Special effects for growth, inflation is acting up.** We expect sluggish economic momentum ahead, with global GDP growing by less than +3% between 2024-25. While growth in the advanced economies will remain stable at +1.6% in 2024, it will slow down to +4% (-0.3pp) for emerging markets, mainly driven by Asia excluding Asean and Latin American countries. The divergence in growth performance between the US and Europe from 2023 is expected to narrow starting in H2 2024. The US is expected to grow by +1.7% in 2025 after +2.4% in 2024 while the Eurozone's growth should accelerate to +1.5% in 2025 after +0.7% in 2024 based on the upcoming positive real income effect. Global trade is exiting recession, but the recovery will be limited by the inventory glut. Continued geopolitical tensions may also limit the rebound in Chinese exports, while downside pressures abound domestically and policymakers ramp up fiscal and monetary easing to cushion the economic slowdown. In the meantime, inflation should be getting closer to target by the summer. The pick-up in sequential core inflation in Europe and the US over the past couple of months has reignited concerns. Yet, we think that disinflation will continue: in Europe due to prolonged stagnating domestic demand and the unwinding of remaining supply constraints, and in the US because aggregate demand is now clearly cooling down.
- **Central bankers' much expected twist: The summer pivot. Beware of the curtain call for fiscal policy.** The Fed is expected to pivot in July and deliver a total of 100bps in rate cuts by the end of 2024 amid progress on inflation. The ECB will be compelled to cut rates before the Fed due to a diverging economic backdrop marked by lower inflation and stagnant output. This slight precedence may exert downward pressure on the euro. The BoE is expected to pivot in August as the economy is bottoming-out already. At the same time, almost all major emerging markets will start a cautious cutting cycle to avoid disturbing portfolio flows. Fiscal consolidation in Europe will be scrutinized and could shave off as much as -1pp off European GDP growth cumulatively in 2024-25. In the US, November election results will determine the course for fiscal, industrial trade and certainly monetary policy. This policy bifurcation may increase transatlantic divergence.

- **Does someone have subtitles for markets? The 2024 soft landing is the trailer; 2025 will be action-packed.** Markets continue to navigate in an unstable equilibrium context in which both fixed income and equities will continue to be influenced by reflation, geopolitics, heightened defense expenditures, reshoring efforts, advancements in artificial intelligence and the transition towards a greener economy. In this context, we expect long-term interest rates to decline in 2024 and 2025 as upward pressure from supply-side factors and higher terminal rates constrain a significant fall (3.8% for the US 10y and 2.2% for the 10y Bund in 2024). Corporate credit will continue to perform on the back of strong balance sheets, normalizing default rates and strong investor demand. In this context and aided by the expected policy pivot in H2 2024, we expect credit spreads to remain close to current levels for the next two years: ~100-120bps for investment grade and 350bps for high yield. Lastly, equity markets will continue to trade between short- and long-term themes, with AI and reshoring being the dominating forces for the time being. Strong trailing and forward earnings paired with a more resilient than expected economic momentum should set the pace for the current equity momentum to turn structural but we believe most good news has already been priced in, thus leaving little room for upside surprises moving forward. Consequently, we expect close to double-digit returns (~10% yearly performance) while we have slightly downgraded our 2025 projections to mid-single digit returns.
- **The plot is a bit hard to follow for corporates – although the premise was intriguing.** Corporate profitability will be tested as pricing power is waning in most of the manufacturing sectors while some exceptions in the services sector are still on (transportation, warehouse and food & accommodation services). Unsurprisingly, an increasing number of firms are expected to implement cost-cutting in the coming quarters. Capex is slowing down amid sluggish growth prospects, high interest rates and lower capacity utilization rates. Lower interest rates ahead mean the corporate debt-repayment wall (40-50% of debt due by 2026) should be manageable, without any major hiccups. But highly leveraged sectors could be increasingly distressed, keeping business insolvencies at high levels: we expect them to increase further in 2024 (+9% after +7% in 2024) before stabilizing at high levels in 2025. Four out of five countries will see business insolvencies increasing in 2024 (+12% y/y on average), with the largest increases likely in the US (+28% y/y), Spain (+28%) and the Netherlands (+31%).



Special effects for growth

Sub-par global economic growth ahead. Global growth is expected to reach +2.7% in 2024-25 after +2.8% in 2023 (Figure 1). While growth in the advanced economies will remain stable at +1.6% in 2024, it will slow down to +4% (-0.3pp) for the emerging markets, mainly driven by Asia excluding Asean and Latin American countries. Growth is slowing in 84 economies, of which 14 are advanced economies (such as the US, Canada, France, Belgium, Spain, Portugal, Greece) and the rest emerging markets (China, India, Indonesia, Turkey, Brazil, Mexico, UAE, Egypt). The divergence in growth performance between the US and Europe from 2023 is expected to narrow starting in H2 2024 (Figure 2). After barely growing since end-2022, the grounds are set for growth in Europe to accelerate, thanks to better prospects for consumer confidence and external demand. In the US, the reduced support from fiscal policy compared to 2023 will be an increasing drag on growth.

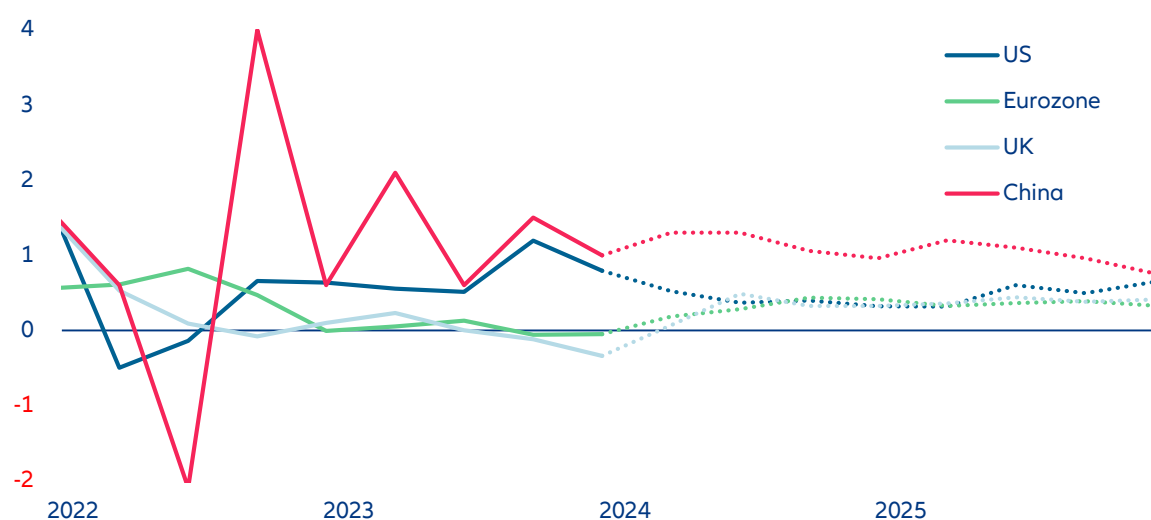
Global trade is exiting recession, but the recovery will be limited by the inventory glut. The inventory-to-sales ratio remains at high levels in a majority of sectors (notably consumer durables, capital goods, high tech,

semiconductors). In addition, capacity utilization rates in industry remain below pre-pandemic levels. While this should keep greedflation in check in the coming months, we believe it will limit corporate investments as well as trade flows. In addition, financing costs are expected to remain restrictive until year-end and historical sensitivities show that +100bps of rate hikes reduce investment by -2pps in the absence of fiscal support measures. While trade in services has been comparatively more resilient, trade in goods was in recession last year and the recovery will be progressive. We expect global trade in goods and services to rise by +3.0% in volume terms in 2024 (after -0.5% in 2023), followed by +3.1% in 2025. In value terms (Figure 2), global trade should rise by +2.8% in 2024 (after -2.9% in 2023) and +5.4% in 2025. Disruptions in global shipping (e.g. the Red Sea crisis lengthening delivery times) and the continued trend of protectionist measures mean that the pace of the recovery is capped and global trade growth in volume is likely to remain significantly below its long-term average (+5.1% over 2000-2019).

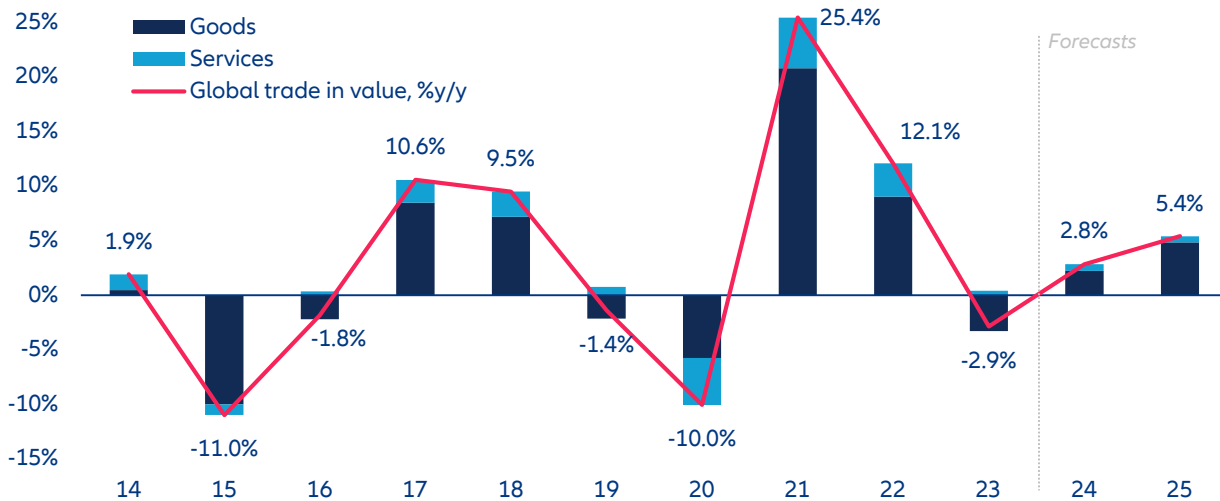
Table 1: Global real GDP growth, %

Growth (yearly %)	2021	2022	2023	2024f	2025f
Global	6.2	3.0	2.8	2.7	2.7
USA	5.8	1.9	2.5	2.4	1.7
Latin America	7.0	3.9	1.9	1.5	2.3
Brazil	5.1	3.1	2.9	1.7	1.9
UK	8.7	4.4	0.1	0.4	1.5
Eurozone	5.9	3.4	0.5	0.7	1.5
Germany	3.1	1.9	-0.3	0.1	0.9
France	6.4	2.5	0.9	0.7	1.3
Italy	8.3	4.2	1.0	0.7	1.4
Spain	6.4	5.8	2.5	1.8	1.9
Central and Eastern Europe	6.1	0.8	1.0	2.1	3.1
Poland	6.9	5.3	0.2	2.2	3.1
Russia	5.6	-1.2	3.6	2.7	1.5
Türkiye	11.4	5.5	4.5	3.6	3.9
Asia-Pacific	6.5	3.2	4.5	4.1	4.0
China	8.5	3.0	5.2	4.8	4.3
Japan	2.7	0.9	1.9	0.6	1.0
India	8.9	6.7	7.7	6.4	6.5
Middle East	4.4	6.2	1.4	2.0	2.8
Saudi Arabia	4.3	8.7	-1.1	1.8	4.2
Africa	5.8	3.9	2.6	3.4	4.0
South Africa	4.7	1.9	0.9	1.4	1.6

Sources: Allianz Research

Figure 1: Quarterly real GDP growth rates, q/q, %

Sources: LSEG Datastream, Allianz Research

Figure 2: Global trade of goods and services in nominal terms, y/y

Sources: LSEG Refinitiv, Allianz Research

Significant downside risks loom from the political landscape, with close to 60% of global GDP going to the polls this year, while global economic uncertainty stands above trend already. The global order is increasingly fragile and more volatile, posing risks for the entire world. The competition between political systems in the US and China, coupled with the ambitions of assertive emerging economies seeking to enhance their global influence, is shaping a more fragmented and multipolar world. Moreover, the global economy is undergoing significant transformations, challenging old economic models and revealing their unsustainability while viable alternatives are still evolving, which leads to growing divergence and fundamental uncertainty. Against this backdrop of political and economic volatility, the year 2024 will be pivotal due to major elections worldwide, including in the US, India, Mexico, the EU, South Africa and the UK. These elections will create a high level of uncertainty not only at the national level but also across the broader political and economic landscape, potentially exacerbating societal tensions. This risk is heightened by increased political

polarization and democratic erosion. Mounting pressures on public finances are expected to intensify debates over spending priorities. Various policy needs will vie for limited budgetary resources amidst unpredictable shocks from geopolitical, financial, defense, health or climate-related events. Ongoing instability carries risks of new conflicts and spillovers from existing ones, as well as heightened migratory pressures and disruptions to trade and supply chains. The tone of the 2024 US presidential campaign and its outcome pose risks to Western unity and alignment on foreign policy matters. Further deterioration in US-China relations could exacerbate the downside risks, particularly given vulnerable supply chains, shifting trade dynamics and resurgent industrial policies.



Inflation is acting up

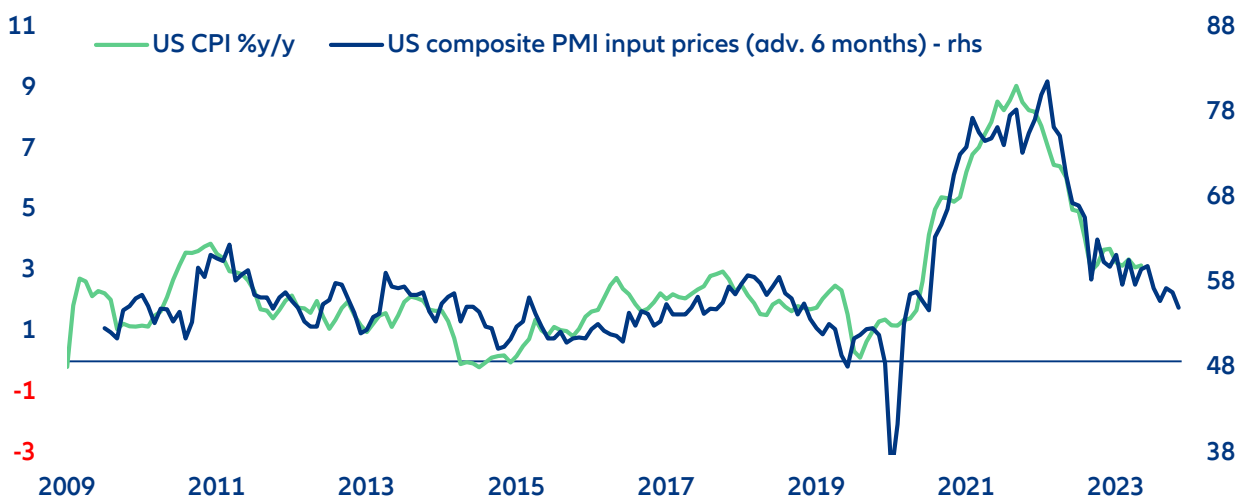
Services price stickiness is stalling disinflation progress while prices for goods remain supportive. The unwinding of supply-chain disruptions as well as lower commodity prices pushed down goods and food inflation over 2023. We expect this trend to continue as oil prices should average 83 USD/bbl on in 2024, in line with 2023, and 81 USD/bbl in 2025. The decline in headline inflation has been more pronounced in the Eurozone than in the US, though: US CPI inflation has been stuck above 3% since June 2023, while in the Eurozone it fell below that threshold in October 2023. These contrasting inflation dynamics are mostly the reflection of much stronger domestic demand in the US than in Europe. Services inflation (excluding shelter), which is most sensitive to domestic conditions (rather than commodity prices and supply-chain constraints) has picked up since the autumn of 2023 in the US while it has pulled back in the Eurozone. Nevertheless, over the past few months, sequential Eurozone core inflation has picked up pace amid higher services prices. This could partially reflect some pass-through from elevated growth in unit labor costs: wage growth is still running high, though slowing down, while productivity growth remains dismal. In addition, supply constraints continue to put upward pressures on services prices. This is consistent with the fact that many companies in the services sector continue to report labor shortages as a factor limiting production.

But continuing loosening of the labor markets should support lower inflation by the summer. Against this backdrop, labor markets have generally continued to loosen. In the US, the voluntary quit rate, which is one of the best gauges of labor market tightness, has dropped rapidly. This signals further wage deceleration this year. Meanwhile, incoming data indicate that GDP growth has been slowing since the beginning of the year (see below), which should ease price pressures in coming quarters. In the Eurozone, it should not be long before elevated inventories and muted demand weigh on prices. European labor markets are also loosening, with less and less companies reporting labor shortages as a constraint on production, according to the EC surveys. The job-worker gap, which is a measure of the labor market supply and demand imbalance, has continued to decline, though progress have stalled in Italy and the UK recently amid lower labor supply growth. In all, business output and input prices surveys, which are a reliable gauge of four-to-six month inflation, generally point to continued core disinflation both in the US and European countries (see Figure 3 for the US), including for services prices. In all, we expect headline inflation to hover below 2.5% by the summer in the Eurozone and the UK. In the US, we expect CPI inflation to break below 3% by May-June and PCE inflation (the Fed's targeted measure of inflation) to hover around 2.3%.

Table 2: Inflation forecasts

Inflation (yearly %)	2021	2022	2023	2024f	2025f
Global	4.3	8.4	6.8	5.2	3.6
USA	4.7	8.0	4.1	2.7	1.9
Latin America	13.9	14.9	24.3	25.9	11.8
Brazil	8.3	9.3	4.6	4.2	3.5
UK	2.6	9.1	7.3	2.6	2.2
Eurozone	2.6	8.4	5.4	2.4	2.2
Germany	3.1	6.9	5.9	2.5	2.2
France	1.6	5.2	4.9	2.3	1.7
Italy	1.9	8.2	5.6	2.0	2.0
Spain	3.1	8.4	3.5	3.1	2.3
Central and Eastern Europe	8.1	9.1	11.0	4.1	3.9
Poland	5.1	14.4	11.4	3.7	4.0
Russia	6.7	13.8	5.9	6.4	4.5
Türkiye	19.6	72.3	53.9	51.7	24.2
Asia-Pacific	1.7	3.7	2.5	2.0	2.3
China	0.9	2.0	0.2	0.6	1.5
Japan	-0.2	2.5	3.3	2.4	1.6
India	5.1	6.7	5.7	4.6	4.6
Middle East	15.8	10.3	7.7	5.6	5.1
Saudi Arabia	3.1	2.5	2.3	2.5	2.0
Africa	12.4	14.5	20.2	18.3	11.1
South Africa	4.6	6.9	5.9	4.2	3.8

Sources: LSEG Datastream, Allianz Research

Figure 3: US CPI inflation & composite PMI input prices

Sources: LSEG Datastream, Allianz Research

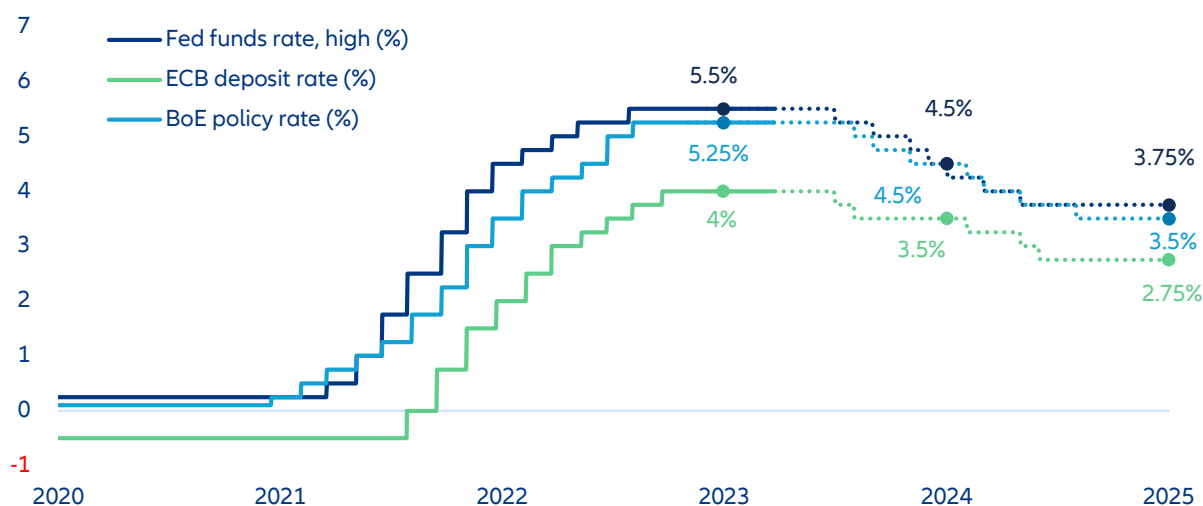
Central bankers' much expected twist: The summer pivot

The Fed is expected to pivot in July and to deliver a total of -100bps in rate cuts by the end of 2024 amid progress on inflation and a more dovish FOMC. As re-affirmed by FOMC members, the Fed's interest rate outlook remains highly conditional on the trajectory of inflation, though they said they will not wait for inflation to reach 2% before pivoting. In its latest Summary of Economic Projections (SEP), the Committee upgraded its GDP growth and core PCE inflation forecasts for end-2024. However, it is noteworthy that they did not change their rate outlook, with 75bps of cuts still expected by year-end. To us, this means that Chairman Powell and a narrow majority of the FOMC feel strongly about not delaying cuts for too long. We infer that the FOMC's "reaction" function has become more dovish: growth is expected to be stronger, and inflation a bit hotter, and yet they are not looking to delay or reduce rate cuts.

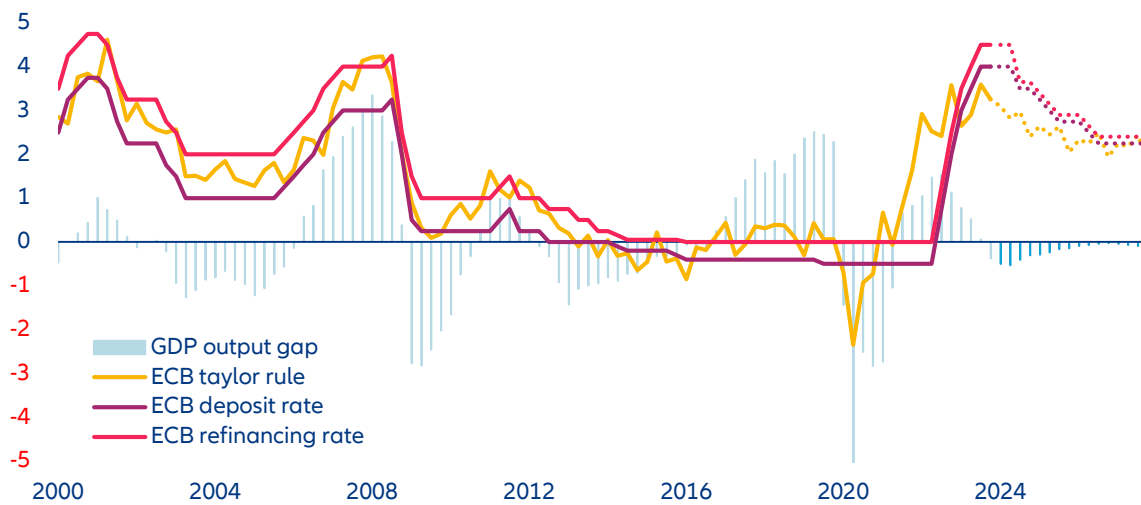
Consistent with our US inflation outlook, with progress expected to be made towards the 2% target in May and June faster than the FOMC forecasts, we think this should be enough to convince the Committee members to pivot in July. Moreover, a slower economy than the FOMC expects by the end of the year should provide a reason for Fed policymakers to cut a little more than implied by the SEP. In all, we think the Fed will deliver a 25bps cut at each of its four meetings for the remainder of the year (July, September, November and December).

The ECB will be compelled to cut rates before the Fed due to a diverging economic backdrop marked by lower inflation and stagnant output. Expected to initiate the rate-cutting cycle in July, nine working days prior to the Fed, the ECB will respond to sustained disinflation improvement and persistent economic stagnation spanning one and a half years. The historical sequence of the ECB following the Fed is more correlation than causation, underscoring the possibility of an ECB lead in this cycle, as emphasized by several ECB governors recently. In past instances like the Global Financial Crisis and the dot-com bubble, initial economic troubles in the US justified the Fed's precedence in rate adjustments. Conversely, during the Eurozone crisis, the ECB actively reduced rates while the Fed remained on hold. Fast forward to today and the current economic split is again increasing, with the Eurozone's inflation at 2.6% and falling whereas US inflation stagnates at 3.1%. Besides, significantly contrasting growth trajectories further highlight the urgency for ECB action amidst increasing overtightening risks. A simple Taylor rule analysis indicates that the ECB is risking being "behind the curve" once more, albeit in the opposite direction from 2022 (Figure 5). Also, the present gap between the current real policy rate and the neutral rate – a measure of policy restrictiveness – is unprecedentedly wide. This disparity is expected to persist even with our forecasted rate reductions as inflation is anticipated to decline concurrently. Hence, we infer that while the Fed might be able to afford to delay further rate reductions, the ECB cannot.

Figure 4: Monetary policy forecasts



Sources: LSEG Datastream, Allianz Research
Note: Dots show Allianz forecasts.

Figure 5: ECB policy rates and Taylor rule, in %

Sources: LSEG Datastream, Allianz Research.

Notes: Dots show Allianz forecasts. Output gap is estimated using an HP-Filter

An earlier ECB rate cut, potentially preceding the Fed's action, may exert downward pressure on the Euro and thereby raise imported inflation. Yet this is deemed negligible as the main driver of inflation remains domestic wage-driven service sector inflation. A slightly weaker euro could instead be a welcome tailwind for the struggling European economy. Looking ahead, after cuts in July and September, a robust economic recovery in the latter half of the year while inflation is still not at the 2% target yet will likely see the ECB pause again in October and December before resuming in 2025 with additional rate reductions. This would also limit the pressure of an ongoing deterioration of the European currency.

The BoE is expected to pivot in August as the economy is bottoming-out already and there is no urgency to move before the Fed or the ECB. We think the BoE will remain cautious before starting to cut interest rates as there is still some uncertainty around wages. The minimum wage will again rise by 9.8% in April 2024, which could boost inflation

by 0.2 to 0.3pp. Overall, we expect wage growth to average 5.3% in 2024 and 3.8% in 2025 after 7.1% in 2023. Further potential inflationary impact might still come from trade disruptions (Red Sea, the implementation of physical checks on imported goods from Europe end of April) as consumption goods in the UK have a 30% import intensity and represent 25% of UK imports. For the latter, avoiding a further depreciation of the sterling from the central bank being more dovish than the other major ones could avoid further inflation from the 10% tariff-equivalent rise in non-tariff barriers. Overall, we expect a -75bps rate cut in 2024 to 4.5% in December, and -100bps in 2025 to 3.5%.

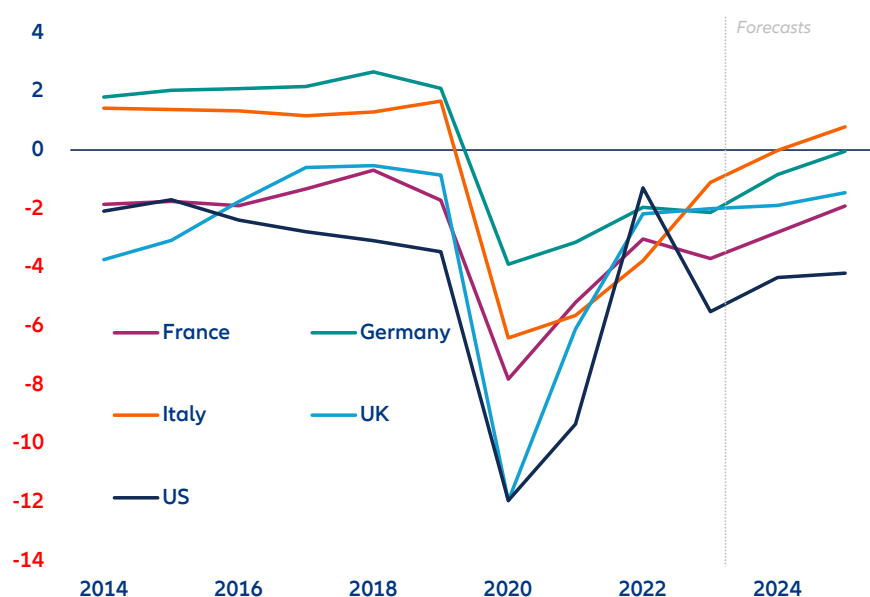
Beware the curtain call for fiscal policy. Fiscal policy adjustments will shave -1pp off European GDP growth cumulatively in 2024-25.

In the Eurozone, we expect only marginal consolidation in the election year ahead of the expected reintroduction of the new EU fiscal framework in 2025. Eurozone governments are trying to tighten their belts after supporting their economies during the dual crisis. The overall fiscal stance expected for 2024 in the Eurozone is around 0.6 (and a further 0.1 in 2025), which represents quite an effort compared to the previous decade's fiscal struggle. Indeed, countries currently face multiple challenges; if their fiscal space is now reduced and consolidation is much needed, the green and digital transitions will require large public investment in the coming years. The new fiscal rules reflect a tight negotiation among EU countries and will set a slow but steady pace of deficit and debt reduction from 2025 over a period of four to seven years. The longer period would be available if a member state undertakes reforms and investments in key priority EU areas such as green and digital transition and defense. But government budget figures and projections available have raised some concerns about future compliance. Available projections for 2025 suggest that six Eurozone countries could breach both fiscal "anchors" (deficit larger than 3% of GDP and debt-to-GDP higher than 60% of GDP). Without considering mitigating factors that the Council and EC will

start considering, France, Spain, Italy, Belgium, Finland and Slovakia could potentially qualify for an Excess Deficit Procedure.

In the UK, further fiscal consolidation will be needed beyond 2025. The 2024 Budget targeted the electorate with a net giveaway of close to GBP14bn or 0.5% of GDP, targeting a further -2pps cut in the national insurance tax for employees (to 8%), freeing on average GBP450 per year for workers, for a total cost of GBP10bn, to which would be added the prolongation of the freeze of the fuel duty (GBP3bn). Overall, these measures will reduce the total fiscal consolidation from 2.1% to 1.6% of GDP in 2024 and by a cumulative of GBP77.6bn (3.1% of GDP) by 2028. However, given that the growth forecasts look optimistic, we believe further tax hikes and spending measures will be needed in the years to come as the increase in the average interest spending on debt reduces the room to maneuver by around 1pp of GDP. Interestingly, since 1990, in the first two fiscal events post-election, taxes have been raised by an average of GBP8bn. Currently, tax revenues stand at 37% of GDP in 2028, +4pps higher compared to 2019 and the highest tax burden since the 1940s.

Figure 6: Primary fiscal balance, % of GDP



Sources: various, Allianz Research

US growth strong, headed for a managed slowdown

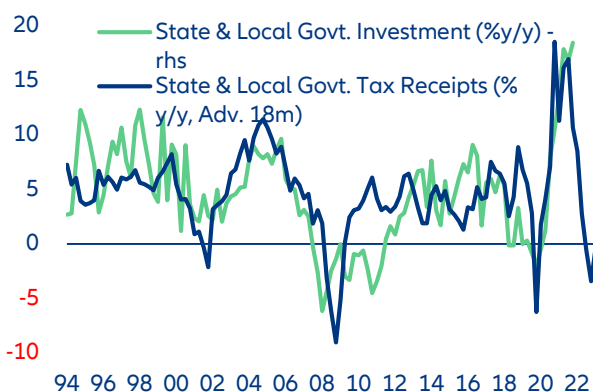
We have upgraded our US growth forecast sharply for 2024 to +2.4%. We now expect US GDP to grow by +2.4% this year, up a full +1pp from our December economic outlook. The first reason is that the US economy ended 2023 on a much stronger footing than expected, with GDP up +3.1% y/y in Q4 2023. The second reason is that we are no longer expecting two quarters of around zero growth in Q2-Q3 2024 (see below). Two areas of noteworthy strengths in 2023 were dynamic public spending and consumer spending. Public spending contributed to a quarter of US growth last year, with local government spending accounting for more than two-thirds of total public spending growth. Moreover, consumers continued to spend more than expected, buoyed by the usage of pandemic excess savings. According to our estimate, US households drew close to USD200bn of pandemic savings in Q3-2023 (non-annualized) and USD220bn in Q4 2023. The rapid rise of the stock market as well as accelerating house prices could have prompted US households to save less and spend more than we had expected. Finally, immigration is estimated to have accelerated last year, boosting the size of the labor force and potential GDP. Recent studies, including one from the Congressional Budget Office, suggest that immigration was as much as 3.5mn in total or 2.5mn above trend in 2023. This is well above the 1.6mn level implied by the change in the foreign-born population in the household survey.

US growth momentum to slow through the year, but remain strong. Incoming data for Q1 2024 indicate that US sequential growth is past its peak and cooling gently. We are expecting growth to reach around +2% annualized in Q1 2024 (from +3.2% in Q4 2023), an upgrade from our December forecast. Looking ahead, growth momentum should continue to soften. First, the fiscal impulse should start to fade. While state and local (S&L) governments still have substantial cash buffers left, budget plans and lower revenues indicate that the frenzy in spending is behind us (Figure 7). At the Federal level, the administration is

now constrained by the deal signed last year with the Republicans in Congress to cap federal spending growth. In all, we expect the general government fiscal impulse to turn mildly restrictive this year. At the corporate level, we are expecting slower investment growth. The strong policy-induced rise in manufacturing plants spending is now fading. Followed-up investment in capital goods should somewhat support capex in the coming quarters but capex intentions are not particularly elevated. More broadly, the last earnings season showed that corporates are prioritizing cost-reduction measures and balance-sheet strengthening amid an environment of prolonged elevated funding costs fueling a rise in bankruptcies. Against this backdrop, we expect consumer growth to cool gently this year, supported by favorable wealth effects and strong, though softening, immigration. We are no longer expecting two quarters of around zero GDP growth in Q2 and Q3 this year, but rather expect a managed slowdown towards +1.3% annualized at end 2024-early 2025.

US growth is expected soften to +1.7% in 2025 but uncertainties are large and will depend on the outcome of the election. The Presidential and Congressional elections of November could shape the US economic outlook substantially for 2025. But uncertainties over the design of policy, particularly fiscal and trade policy, as well as the timing of implementation, are large. In particular, spending and tax policies changes are decided by Congress, with a filibuster majority needed in Senate to push through legislative changes. Therefore, whoever wins the White House could be constrained in crafting substantial legislative changes. For instance, even if re-elected, Biden's flagship proposal to substantially increase taxes on wealthy individuals and corporates may never be pushed through given the relatively little odds that the Democrats win both Houses of Congress. Furthermore, if Trump is elected, the exact timing of his

Figure 7: State & local governments tax receipts and investment



Sources: LSEG Datastream, Allianz Research

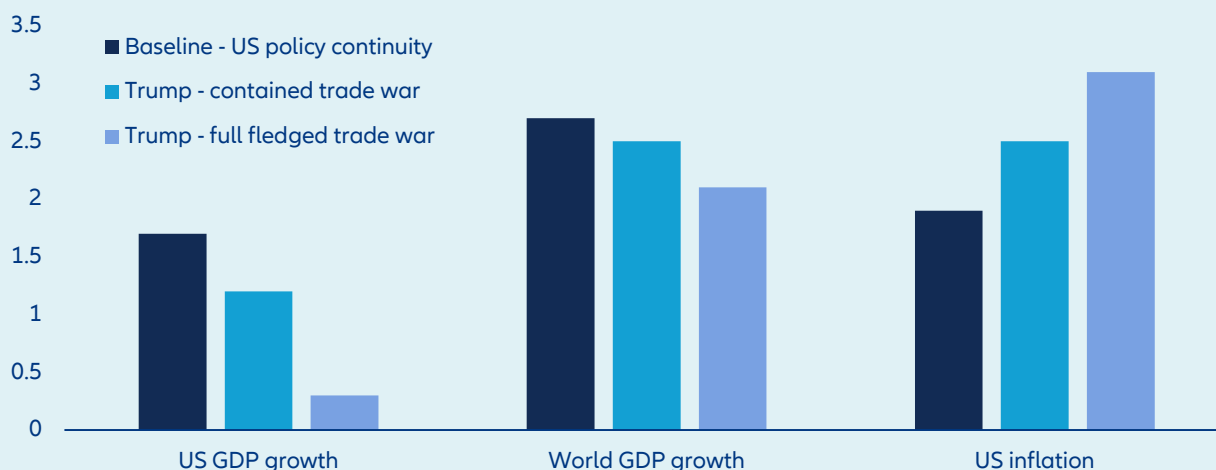
pledged tariff hikes is uncertain: will he first negotiate with trading partners, increase tariffs in a one-off action or favor a step-by-step, escalating approach? Box 1 reviews the two candidates' main policy proposals and what they could mean, if implemented, for the US outlook. Against this backdrop of high uncertainties, we take the view that government policies will be broadly neutral for the growth and inflation outlook in 2025. In particular, we

would expect modest fiscal consolidation to continue next year. Growth should be supported by lower funding costs – with the Fed expected to continue cutting rates – but nevertheless to be lower than in 2024 at +1.7%. We expect consumption growth to slow down amid a normalization of the savings rate and the full exhaustion of pandemic excess savings.

Box 1: US elections and economic outcomes in 2025: a sizeable drag on growth if campaign pledges are implemented

Incumbent President Biden has recently set out his main policy proposals should he be re-elected in November – and with a majority in Congress. On fiscal policy, Biden has pledged to increase the corporate tax rate from 21% to 28% as well as to increase the corporate alternative minimum tax on book income from 15% to 21%. Biden has also pledged to increase taxes on wealthy individuals, by limiting the deductibility of employee pay over USD1 mn per year and increasing a series of taxes for high-income earners, including new Medicare taxes and new 25% minimum tax on incomes over USD100mn. On the other hand, incumbent Biden proposes social spending increases. In net terms, his fiscal proposals would amount to a sizeable tightening of fiscal policy of around 0.8% of GDP per year. Nevertheless, the drag on growth should be somewhat lower as tax hikes target wealthy individuals whose spending would be little affected. Tax increases on corporates would lower investment growth, but in an environment of loosening credit and financial conditions in 2025, as well as elevated corporate cash assets, we think the drag would be lessened. In all, we estimate Biden's fiscal policy to knock around -0.4pp off GDP growth and to lower inflation by -0.2pp, if fully implemented. Finally, we would expect Biden to not renew the 2017 corporate tax cuts, which are set to expire in end-2025. This "fiscal cliff" would create additional headwinds for 2026 growth. In the case of a Trump victory, we estimated in a recent report¹ that Trump would be more likely to water down his promises to increase the US tariff rate to 10% (and 60% on Chinese imports). Under this "contained" trade war scenario, we estimated that US growth would be knocked by -0.5pp (after accounting for fiscal support) and US inflation would be boosted by +0.6pp. Meanwhile, global GDP growth would be lowered by -0.2pp (Figure 1). We estimated modest personal tax cuts to be delivered and no change in corporate taxes, with a Q4 2025 fiscal cliff avoided. However, the uncertainties around the design and the timing of Trump's trade policy are very elevated and so the variance around the US scenario in 2025 would be higher under a Trump presidency versus a Biden presidency. In particular, in case of a near full implementation of Trump's pledges on tariffs, we estimate the GDP drag would be substantial, effectively pushing the US economy into recession.

Figure 1: Economic impact of a Trump presidency (%)



Sources: Oxford Economics, Allianz Research

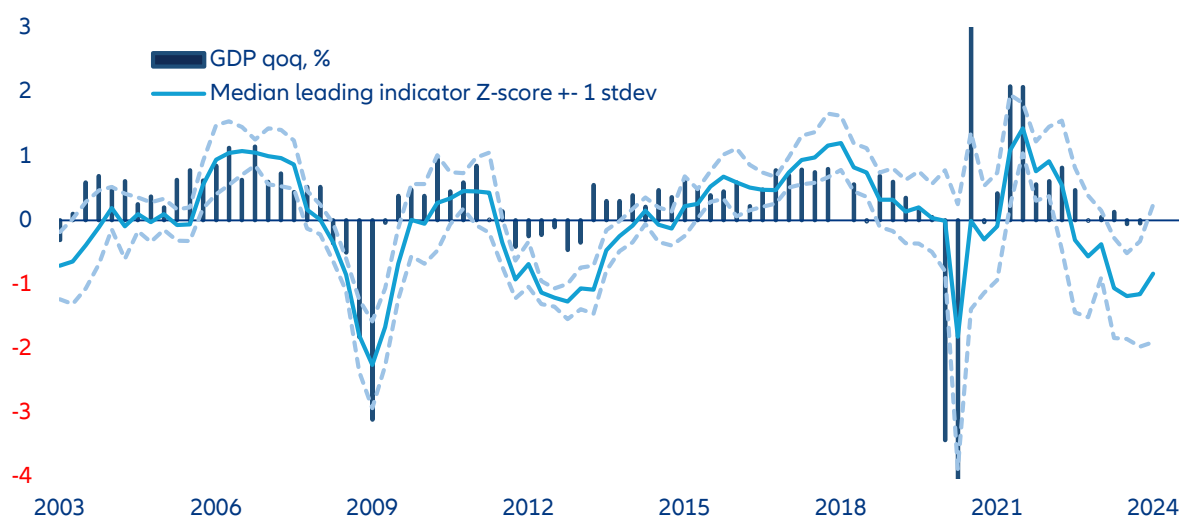
¹ [Trumponomics: the sequel \(allianz.com\)](https://www.allianz.com/en/insights/trumponomics-the-sequel)

Eurozone set for a recovery from stagnation but downside risks along the way

Our Eurozone outlook remains largely unchanged as upward revisions in Italy and Spain counterbalance the downward revision of Germany. Economic growth is expected to accelerate in the second half of this year, following a period of nearly one and a half years of stagnation. Strong wage growth is expected to provide some support to the European consumer, which has suffered significant losses in purchasing power during the recent phase of double-digit inflation. Moreover, the region is set to emerge from the current negative output gap, indicating that economic activity is set for a mechanical recovery, assuming no structural downward revision of the region's growth potential. Lastly, -50bps of interest rate cuts by the ECB in the third quarter should give some additional economic tailwind. Germany remains the clear underperformer in the region, facing challenges from a tight fiscal stance, high energy costs and sluggish global demand for its industrial export-oriented industry sector. Structural issues such as substantial red-tape and the lack of integration of potential foreign workers into the workforce weigh on the supply side. On a positive note, Italy, Spain and several smaller economies are filling the economic growth gap, thanks to thriving domestic demand.

Risks are tilted to the downside in the Eurozone as leading indicators signal continued near-term sluggish growth amidst substantial uncertainty. Figure 8 displays the median of a collection of standardized leading indicators, including credit demand, purchasing manager surveys and economic sentiment among businesses and consumers. Two things stand out: first, despite a slight improvement, the indicator suggests the possibility of another low or even negative growth rate in the near term. Secondly, the confidence interval is significantly broader than in past cycles, underscoring the prevailing economic unpredictability. The aftermath of two major supply-side shocks – the Covid-19 pandemic and the energy crisis triggered by Russia's attack on Ukraine – continues to produce considerable volatility in economic indicators. A gradual movement towards a new economic equilibrium is ongoing but hiccups along the way should not come as a surprise.

Figure 8: Eurozone economic growth in % and median leading indicator, Z-score



Sources: LSEG Datastream, Allianz Research

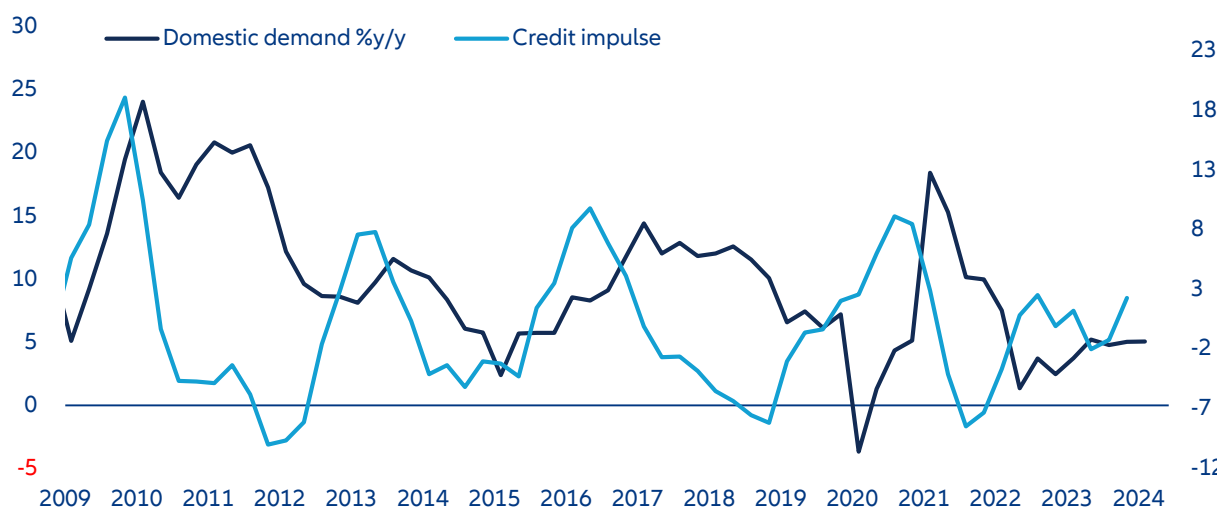
Notes: Median leading indicator is the median of several normalized leading indicators (Z-scores) such as PMIs, change in credit demand, economic sentiment, consumer confidence.

Emerging markets: an overall slowdown but with some bright spots

China: policy support is key to cushion the economic slowdown. We expect GDP growth at +4.8% in 2024 and +4.3% in 2025 (after +5.2% in 2023). Chinese authorities have kept this year's growth target unchanged at "around 5%". Without last year's post-Covid boost and amidst low corporate and consumer confidence as well as a continued real estate downturn, this will be a tall order. Policymakers are sending the signal that while they want to prevent structural risks from deteriorating, they are also focused on supporting the economy this year. Further policy efforts should help support domestic demand (Figure 9). In particular, on the fiscal side, authorities have committed to issue ultra-long central government special bonds for the next few years, starting with RMB1trn this year. This is a policy tool that had only been used in the past during crises (2020, 2007 and the late-1990s), and should help shift some fiscal funding responsibilities from local governments to the central government, as the former have been under pressure in part due to the real estate downturn (and thus lower revenues from land sales). To facilitate fiscal easing and in the context of low inflation, we expect another cut from the PBOC in both

the reserve requirement ratio and the one-year loan prime rate in the coming months (after already -50bps in the reserve requirement ratio and -25bps in the five-year loan prime rate so far this year, both having exceeded expectations). Furthermore, targeted policies such as subsidies and trade-in programs can be expected to support consumer spending and corporate investment. Real estate investment will remain a drag this year, with policymakers primarily focusing on construction and the supply of affordable housing (the "new model of housing development"). While housing completions performed well last year, very weak housing starts since mid-2021 could ultimately result in a completions cliff going into 2025, maintaining a drag on overall economic activity. Finally, export conditions are likely to improve this year, though increasing geopolitical tensions will limit the extent of the rebound. Overall, downside pressures abound and the challenge for policymakers is to reestablish confidence and support new growth drivers² to establish a sustainable – though slowing – economic model in the long run.

Figure 9: China domestic demand % y/y and credit impulse index (leading by two quarters)



Sources: national sources, Allianz Research

² [China: keeping the dragon awake \(allianz.com\)](https://www.allianz.com)

Emerging market economies overall will see a slowdown to +4% (-0.3pp) in 2024, mainly driven by Asia excluding ASEAN and Latin American countries. Apart from Southeast Asia and a few other exporters benefiting from global supply-chain rewiring, external trade flows for major EM regions are expected to only stabilize in 2024 and will not be a key growth driver. In Emerging Asia, ASEAN is likely to be the bright spot this year, growing by +4.5% after +4.2% in 2023 (though this remains below the 2010s average of +5.3%). Emerging Europe should experience a gradual recovery in 2024, thanks to rebalancing, lower inflation and monetary easing. Conversely, growth prospects remain under pressure in the Middle East and Africa due to unfavorable commodities prices (in particular, below fiscal breakeven oil prices for the former and elevated food prices for the latter), and Latin America should see a further growth slowdown in 2024, before a mild recovery in 2025. Looking more specifically at exports, following weak trade flows in 2023, a gradual recovery kickstarted during the last quarter of the year. In our baseline scenario, we forecast trade to improve this year compared to 2023 but we do not expect a strong recovery (apart for some exceptions) against the backdrop of subdued global growth and demand for goods from EMs. Potentially extended trade disruptions are a downside risk to our expectations. Following the Panama Canal disruptions in the second half of 2023, the PMIs for supply delivery times have markedly worsened in Latin America, especially in Brazil and Colombia. And escalations in the Red Sea towards the end of 2023 have increased supply delivery times in Emerging Europe. Meanwhile, supply delivery times in Emerging Asia have hardly been affected. Overall, many EMs are forecast to see a moderate growth recovery this year, which will mostly be driven by domestic consumer spending and investment activity.

Currency devaluation across EMs: a political strategy unfolds? As already highlighted, this electoral year is pivotal for geopolitics. Yet, elections also offer a chance for impactful, albeit unpopular, policy changes locally, with foreign exchange (FX) being one of the tools. Most major emerging markets (EMs) operate with relatively free-floating exchange rates. However, many countries with less financial integration opt for pegged or tightly managed floating rates, with all, large and small, intervening to reduce volatility.

Amidst stressed balances of payments and high interest rates in advanced economies, these exchange-rate-related policies have become unsustainable in many countries. Moves to devalue a currency, often adopted to mitigate unsustainably high interest rates and avoid reserve depletion, are broadly unpopular due to their impact on, among others, savings, the fair value of assets and, of course, purchasing power. Such unpopularity leads governments to defer these necessary adjustments until after elections, with the heavy costs of maintaining them in the months prior to the election and the choice between free floating or re-pegging afterwards. This trend has been evident in the last few months, as seen in the cases of Argentina, Egypt, Nigeria and Türkiye, where currency devaluations were implemented right after elections with different outcomes in terms of re-pegging and parallel market values. Looking ahead and based on our previous research on currencies at risk³, we think that the same story could repeat in Pakistan (which held elections in February), Türkiye, Tunisia and the CFA Franc area later in the year. Similarly, devaluations could spiral, as has become evident in the case of Nigeria. Even in countries with a floating rate regime like South Africa, elections could create an opportunity to undertake significant economic changes with a direct impact on the exchange rate.

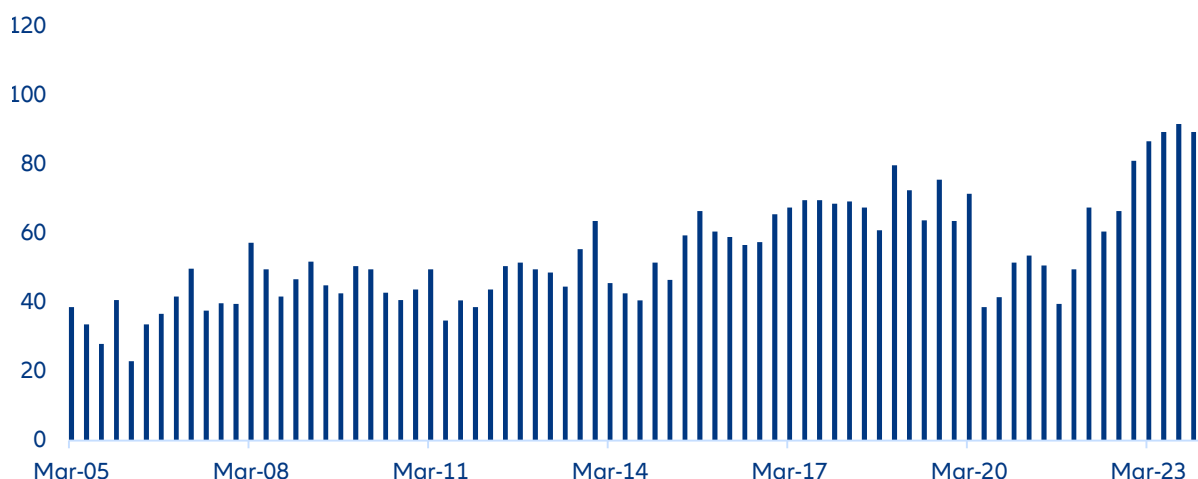
³ [What to watch | February 08, 2024 \(allianz.com\)](https://www.allianz.com/en/insights/what-to-watch/February-08-2024)

The plot is a bit hard to follow for corporates

Corporate profitability will be tested as pricing power is waning. Consumer demand is slowing down as we expect sluggish economic activity in most economies and especially in Europe. As a consequence, inventory is piling up. In most sectors, European firms have more stocks in their warehouses than their US competitors. The European auto industry is the only outlier with a very low level of inventories. Furthermore, firms have to deal with still-high operating costs as wages continue to increase; oil and transportation remain expensive and supply-chain issues are still impacting some products. Against this backdrop, many firms do not have the leeway to increase prices to protect profitability. In the US, according to the NFIB survey, only 21% of businesses expect higher selling prices

while in Europe this share is less than 4% of manufacturers. From an industry standpoint, a number of services sectors are still planning to increase prices (e.g. airlines, shipping) but the upside risk seems limited for manufacturing sectors. Unsurprisingly, an increasing number of firms are expected to implement cost-cutting in the coming quarters (Figure 10).

Figure 10: Mention of “Operational efficiency” in US earning calls



Sources: Bloomberg, Allianz Research

Capex is slowing down amid sluggish growth prospects, high interest rates and lower utilization rates. Looking at a sample of about 3,000 global listed firms shows a deceleration of capital expenditures in the US at +8% in 2023, down from +11% in 2022. Over the same period, Chinese firms saw a decline of -14% in capex. In firms from the six largest Eurozone countries (i.e. Germany, France, Italy, Spain, Belgium and the Netherlands), capex continued to accelerate in 2023 (+13% up for +8 in 2022). However, this positive figure is mostly explained by investments in the energy sector as the continent is still grappling with an energy crisis. On top of weak demand and high interest rates, capacity utilization rates do not plead for more investments in most countries. Indeed, as of early 2024, they stood at 63% in the UK, 81% in both France and Germany and 75% in Italy. These figures are all shy of historical highs.

Incoming lower rates means the debt wall should be manageable. Between now and the end of 2026, 40% of US firms' debt and 50% of that of European firms will come due. This pile of debt maturing in the next couple of years was also boosted by the strategy of some companies to keep interest expenses in check by issuing debt at shorter maturities (one or two years) to benefit from the lower interest rates at the low-end of the curve. This strategy along with resilient revenues have allowed most corporates to maintain their interest-coverage ratios at solid levels. As interest rates should decline by 2026, we expect that the bulk of maturing debt should be repaid or rolled-over without any major hiccups.

Insolvencies should accelerate further in 2024 with an increase of +9%. The number of business insolvencies rebounded in three out of four countries in 2023, with most recording a double-digit increase. Overall, our global insolvency index increased by +7% y/y for the full year 2023, up from +1% in 2022. Looking ahead into 2024, we expect another acceleration in global business insolvencies in 2024 (+9% y/y), before a stabilization at a high level in 2025. Four out of five countries will see business insolvencies increasing in 2024 (+12% y/y on average), with the largest increases likely in the US (+28% y/y), Spain (+28%) and the Netherlands (+31%). The broad-based rise would push two out of three countries above their pre-pandemic number of insolvencies in 2024 (2016-2019 average), up from half in 2023. In 2025, however, we expect a stabilization of our Global Insolvency Index, with a majority of countries posting a trend reversal (-9% y/y in simple average for the countries concerned). European countries in particular would see the largest decreases, most often from a strong bounce-back over 2021-2024 and/or from a historic high.

Capital markets outlook

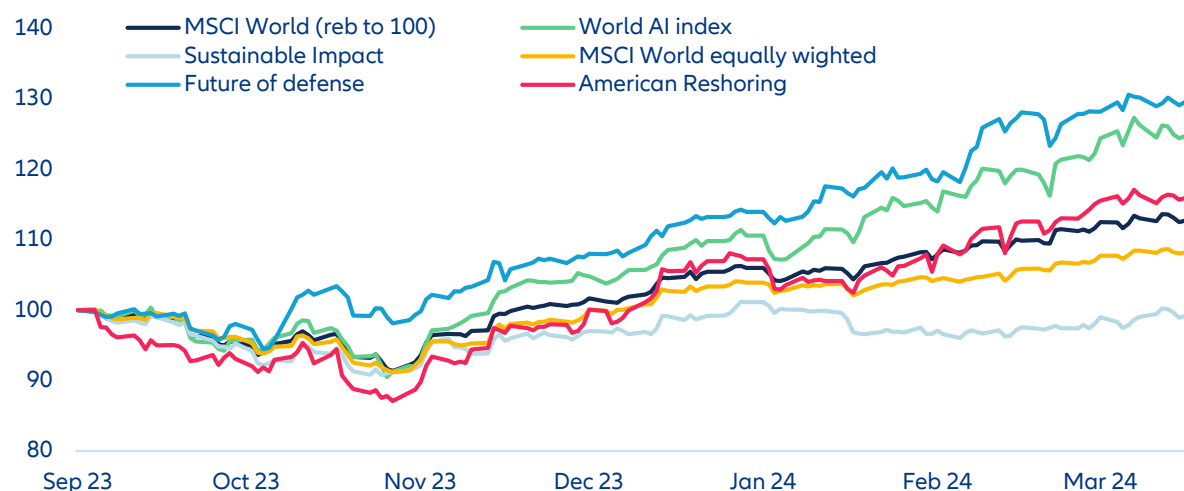
The 2024 soft landing is the trailer; 2025 will be action-packed.

Throughout the initial months of the year, capital markets have consistently responded to the news flow as a mix of immediate and enduring market and economic trends persist in dictating investors' risk appetite. On one side, persistent inflation has delayed expectations for the pivot in monetary policy. The shift has sparked a notable increase in both the short- and long-term segments of sovereign yield curves, with adjustments in the range of 30-40bps upwards. There continues to be a notable upswing in the realm of corporate debt as companies bask in favorable conditions amid a resilient earnings season, sturdy balance sheets, the absence of immediate refinancing pressures for high-yield debt and, chiefly, consistent demand from investors eager to secure higher yields, anticipating a decline when central banks eventually pivot. Finally, equities are once again bucking the trend seen in sovereign bonds as investors pivot away from concerns over interest rate sensitivity and valuation changes towards the underlying fundamentals. This shift in focus is largely due to the resilient earnings growth demonstrated by the mega caps and the technology sector, as well as the potential benefits of a favorable underlying "reshoring" trend. Moreover, the prospect of

a second term for Trump is particularly noteworthy in influencing investor sentiment and market dynamics as the "America First" narrative is appealing not only to US investors but to rest of the world (Figure 11).

Going forward, we expect markets to gravitate towards a positive correlation state between sovereign bonds and risky assets in both 2024 and 2025. The expected policy pivot will pull down the long end of the sovereign curve, while equities are expected to maintain positive performance owing to resilient earnings growth and upward valuation adjustments. In general, and given the current unstable equilibrium, we expect both fixed income and equities to be influenced by the most recent short- and long-term trends, including reflation, geopolitics, heightened defense expenditures, reshoring efforts, advancements in artificial intelligence and the transition towards a greener economy. These trends will prompt rotations both along the sovereign curve and within equity and corporate market sectors, making the remaining three quarters of the year more dynamic than usual.

Figure 11: Global equity performance by theme



Sources: LSEG Datastream, IBES, Allianz Research

Table 3: Capital market forecasts

EMU	Last	Unit	2022	2023	2024f	2025f
Government Debt						
ECB deposit rate	4.00	%	2.00	4.00	3.50	2.75
10y yield (Bunds)	2.40	%	2.56	2.03	2.20	2.10
10y EUR swap rate	2.69	%	3.14	2.48	2.60	2.50
20y EUR swap rate	2.64	%	2.87	2.51	2.70	2.70
<i>Italy 10y sovereign spread</i>	127	bps	213	168	130	120
<i>France 10y sovereign spread</i>	44	bps	55	53	40	30
<i>Spain 10y sovereign spread</i>	80	bps	109	97	80	70
Corporate Debt						
Investment grade credit spreads	112	bps	166	135	120	120
High-yield credit spreads	335	bps	494	395	360	350
Equity						
Eurostoxx (total return p.a.)	9 ytd	%	-12	19	7	10
US						
Government Debt						
Fed Funds rate (high)	5.50	%	4.50	5.50	4.50	3.75
10y yield (Treasury)	4.28	%	3.83	3.87	3.80	3.60
Corporate Debt						
Investment grade credit spreads	91	bps	138	104	100	100
High-yield credit spreads	305	bps	479	334	350	330
Equity						
S&P 500 (total return p.a.)	10 ytd	%	-18	26	11	8
UK						
Government Debt						
BoE rate	5.25	%	3.50	5.25	4.50	3.50
10y yield sovereign (Gilt)	4.00	%	3.67	3.54	3.60	3.40
Corporate Debt						
Investment grade credit spreads	111	bps	192	134	120	115
High-yield credit spreads	415	bps	663	515	440	410
Equity						
FTSE 100 (total return p.a.)	3 ytd	%	5	8	5	5
Emerging Markets						
Government Debt						
Hard currency spread (vs USD)	204	bps	273	215	225	220
Local currency yield	6.28	%	6.86	6.19	6.00	5.60
Equity						
MSCI EM (total return p.a. in USD)	3 ytd	%	-20	10	6	10
Others						
EUR USD	1.09	\$ per €	1.07	1.10	1.12	1.13

Sources: LSEG Datastream, Allianz Research

Long-term interest rates are poised for a modest decline in 2024 in line with easing monetary policy but upward pressure from supply-side factors as well as higher terminal rates constrain larger falls. The beginning of monetary policy easing in July will exert some downward pressure on long-term rates. Moreover, as the disinflation trend continues, inflation expectations, another key determinant of long-term yields, will also diminish. However, terminal rates expected by the end of 2025 will remain substantially higher than those seen in the past decade. Furthermore, an abundant supply of government bonds due to high fiscal deficits, alongside quantitative tightening that will persist even if central banks reduce their policy rates, will prevent yields from falling significantly from current levels.

Volatility in rates markets is set to decline as uncertainty surrounding monetary policy diminishes. Although rate market volatility has normalized further, it remains above previous levels, largely because of continuing monetary policy uncertainty. With market-based inflation expectations stabilizing, it now appears that the market is confident in the successful battle against inflation, with the remaining question being the duration of restrictive monetary policy. As this uncertainty decreases with the initial rate cuts starting this summer, we expect a significant reduction in rates volatility.

Risk sentiment is gradually improving, leading to a continuous normalization in government bond and swap spreads. The yield gap between 10-year Italian government bonds and German bonds has significantly narrowed in recent months, thanks to robust retail demand in Italy, the anticipation of monetary policy easing and renewed momentum towards European integration, including discussions on reviving progress towards a capital market union. Another factor contributing to narrowing spreads is the “subtrahend” of the equation: Germany. The ongoing economic weakness of Europe’s economic powerhouse has shifted attention away from traditionally weaker Eurozone countries, thereby reducing demand for safe-haven bonds. This, in turn, has resulted in comparatively higher German bond yields and ultimately also explains part of the narrowing in swap spreads.

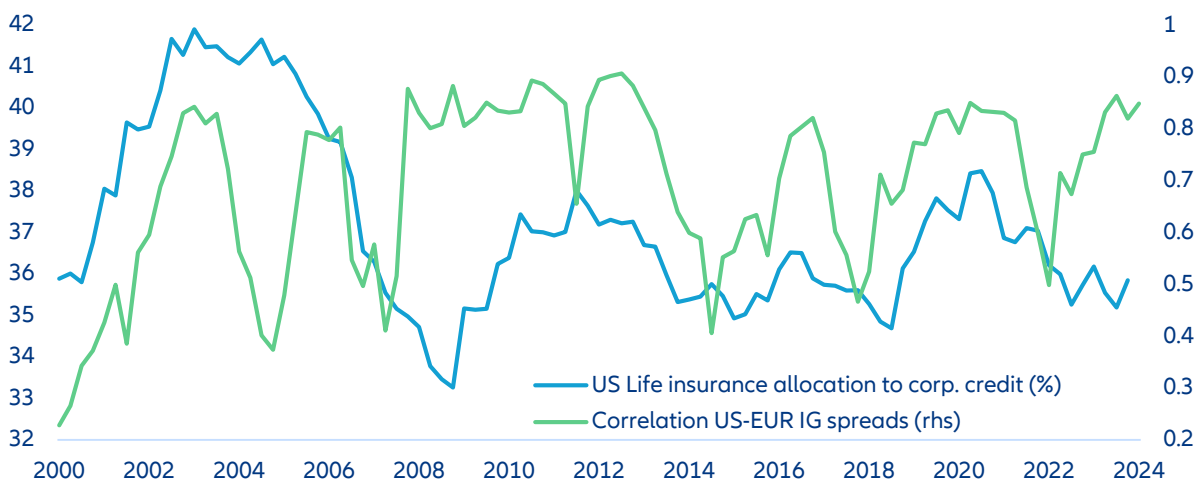
Anticipated shifts in real interest rate differentials indicate a gradual depreciation of the US dollar against the euro starting in the second half of this year, in line with our expectations of a slowdown in the US alongside a resurgence in the Eurozone. The euro is expected to benefit from these conditions, especially from a more favorable interest rate scenario, as we predict fewer ECB rate cuts in 2024 relative to the Fed. Additionally, the USD appears overvalued from a long-term real effective exchange rate perspective, further suggesting potential for normalization ahead. However, the Eurozone is facing substantial downside risks, including the threat of continued economic stagnation that may compel the ECB to undertake more extensive monetary easing. While the USD traditionally gains strength during US election years, we anticipate that fundamental factors and valuation considerations will predominate this year, leading to a different outcome.

Credit continues to enjoy a supportive environment. Corporate credit has been performing positively since the beginning of the year as it continues to attract investors following a couple of years of mild but sticky outflows. Undoubtedly, the improved US economic performance is providing a substantial sentiment boost for credit investors, which in turn is dragging European corporates along despite a more bearish outlook in the region. At the same time, the expected rapid decrease in inflation pressures during the second half of the year, alongside the resulting shift in monetary policy by central banks in both the US and Europe, is also bolstering credit markets, both in terms of overall yields and credit spreads. However, even if inflation remains more stubborn than anticipated, postponing interest rate reductions, this may not significantly alter the ongoing trend in corporate spreads, thanks to an improved growth outlook, decent earnings and debt-servicing resilience. It could still affect corporate credit yields through a rise in long-term interest rates. Nonetheless, we do not believe that this upward shift would counterbalance the full excess return for the asset class.

Robust corporate profitability bodes well for debt-repayment. Companies managed to maintain gross margins in the second half of 2023 despite somewhat weaker sales, mainly because of effective cost controls and easing inflation, which led to lower labor and material costs. The start of 2024 has marked a significant rebound in credit demand across various investor profiles, reverting part of the outflow trend from last year. Notably, yield-seeking investors have shown remarkable interest since last summer’s rate sell-offs. Given the strong and resilient demand and the potential for further engagement throughout the year, there seems to be ample room for continued robust demand, especially from pension funds and insurance companies whose allocation to credit remains low (Figure 12). Of course, all this bullish rotation is being accompanied by a slower acceleration of distressed debt and defaults, propelling the ongoing corporate rally. Taking all this into account, we have revised down our corporate spread forecasts for 2024 and 2025, as we believe current macroeconomic and fundamental forces point towards overall credit market resilience and optimism. In this regard, we expect investment grade credit spreads to finish the year at 100-120bps and high-yield spreads at around 350bps, with sideways trading likely in 2025.

The bull market in equities is continuing its upward trajectory, primarily propelled by a select group of companies. Following a solid performance in the fourth quarter of 2023, equity markets have accelerated, driven by a resurgence in positive sentiment towards the technology sector and several mega-cap stocks, pushing global equity indices to unprecedented levels. This momentum is supported by several factors, notably earnings both overall and within the technology sector, which has been outperforming the broader market, lending some credibility and stability to the rally’s strength. Furthermore, key players within these market-leading companies are not only exceeding financial expectations but are also enhancing shareholder value through mechanisms such as share repurchases and generous dividend payouts. The rally has increased concerns around high valuation metrics, such as the price-to-earnings ratio in the technology sector, but it is important to note these figures remain significantly below the speculative peaks observed in the early 2000s or in 2021, suggesting that the market’s current trajectory may still have room to grow.

Figure 12: US life insurance companies’ allocation to corporate credit and correlation between US and EUR IG corporate spreads



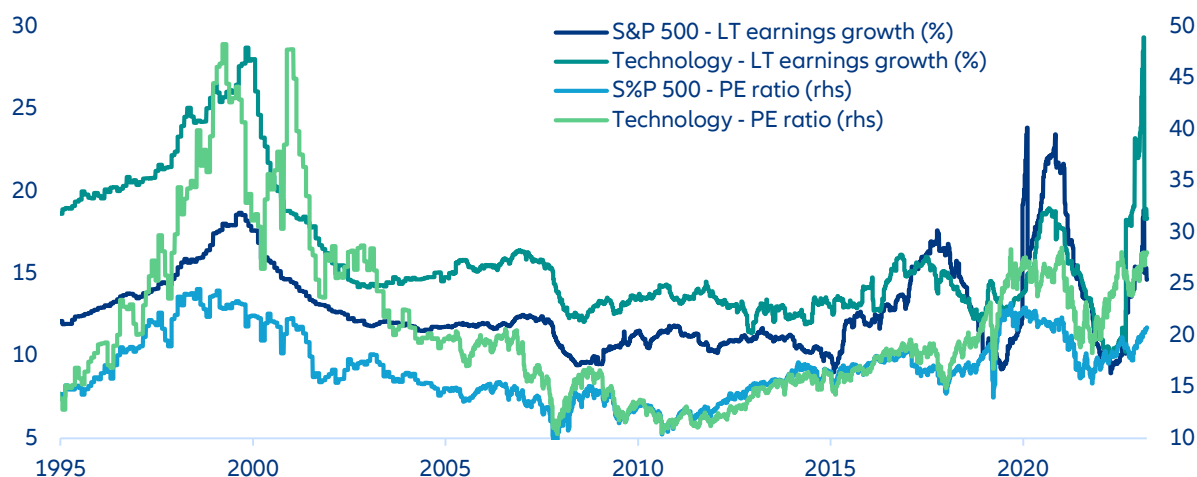
Sources: LSEG Datastream, IBES, Allianz Research

Geographical (US), sectoral (technology) and company (Magnificent 7 / Granolas) concentration remains a potential vulnerability for market dynamics. While equity market concentration is somewhat mitigated by strong earnings growth, healthy balance sheets and minimal leverage, the steep ascent in certain equity indices' prices indicates that even a minor shift in investor sentiment could significantly slow the pace of price increases. We anticipate that a mix of short-term and long-term trends will continue to steer equity markets' trajectory. In the near term, the focus on AI developments and a shift towards "reshoring" and defense sectors, driven by the upcoming US elections, are likely to influence market sentiment. In the longer term, the transition to climate-friendly practices and sustained reshoring efforts are expected to take precedence. In this situation, we expect the decoupling between equity and sovereign bonds to continue for as long as there is no big change in the expected policy pivot. While the anticipated shift in thematic focuses does not inherently pose a risk, it could prompt a sector rotation that may lead to capital moving away from current market leaders to other emerging sectors such as industrials, capital goods and banks. This rotation could potentially result in capital outflows effectively capping the market upside potential. All in all, we have raised our 2024 equity forecasts to close to double-digit returns (~10% yearly performance) while slightly downgraded the outlook for 2025 to mid-single digit returns (Table 3). With these forecasts it is fair to assume that most good news and optimistic expectations have been mostly priced in and there is little room for upside surprises moving forward.

Measured optimism for private equity and private debt.

Over the previous year, the private equity space has encountered challenges, with heightened short- and long-term interest rates adversely impacting valuations and acting as a barrier to market entry. Consequently, there has been a notable accumulation of uninvested capital, or "dry powder," as investment activity has decelerated significantly and return expectations have plummeted. We expect that the shift towards lower interest rates, coupled with a resurgence of market confidence, could catalyze a revival in the private equity arena, particularly within sectors aligned with digital transformation, sustainability efforts and reshoring. Despite this guarded optimism, it is important to recognize that the realization of cash flows back to investors may require additional time to materialize as the deal pipeline, despite accelerating, may take some time to go back to historical levels. Private debt has also seen a period of increased attention, a trend that is expected to persist as investors continue to look for higher floating yields, positioning it as an attractive option over conventional instruments for inflation protection. Nonetheless, obstacles such as market fluctuations, regulatory amendments, the lack of a secondary market and limited transparency remain significant barriers to making this asset class more accessible to the general public. We expect private debt to maintain its growth momentum but lower-grade debt is likely to underperform, with a rise in defaults and insolvencies within the asset class. In this context, selecting the right issuers will increasingly become key in the determination of future returns.

Figure 13: US long-term earnings growth expectations vs PE ratios



Sources: LSEG Datastream, IBES, Allianz Research

Commercial real estate (CRE) is poised to remain challenged in 2024, though systemic spillovers are expected to be limited.

Market participants have mostly acknowledged a structural adjustment in pre-2022 valuations, particularly for non-prime office spaces. The complexity lies in quantifying the adjustment for assets that are not publicly listed. But judging from broad office price indexes by providers like Real Capital Analytics, an overall adjustment of at least 20% from the peak sounds plausible⁴. We do not expect office prices to rebound in the next couple of years but rather to consolidate around end-2023 levels. The critical question now revolves around whether the macro-financial environment will facilitate a gradual absorption of these losses or lead to a disordered sequence of major defaults, triggering a domino effect through the banking system. In our baseline scenario, the next couple of years will see the assimilation of this valuation adjustment within investor balance sheets – a necessary step before a resurgence in activity levels can occur. Naturally, this adjustment – which comes with defaults – is likely to cause problems on the financial system. Using loan loss rates from the latest Fed and European Banking Authority stress tests on the banking systems, our analysis suggests that a CRE downturn could bankrupt some smaller banks and diminish profits for many others, yet it is unlikely to critically compromise the overall banking system's stability. Another argument to support these limited spillovers is the fact that financial and banking regulators in the US and Europe have expressed their preparedness to intervene, supported by both declarations and tangible actions, which have proven effective over the last year. However, in a downside scenario where CRE issues are not isolated, compounded losses across different loan portfolios or the forced realization of losses in other securities due to liquidity events, alongside a (for example) inflationary environment in which central banks are partially constrained, could potentially lead to a more severe banking crisis.

Emerging markets offer both reasons to support current market optimism but also reasons that warrant some caution.

In our baseline scenario, we adopt a glass half-full perspective, a view currently shared by markets. Although spreads of hard currency bonds are tight by historical and fundamental standards, largely due to the late-2023 rally, the yields remain attractive, especially if monetary easing proceeds as expected in advanced economies and policy continuity is maintained after the US elections. According to our forecasts, hard-currency sovereign spreads should reach 225 by year-end, a slight widening from current levels but on a downward trend into 2025. Meanwhile, we expect local-currency yields to gradually decrease to 6% and 5.6% by the end of 2024 and 2025, respectively. In this scenario, we project that total returns from EM equities (6% using the MSCI EM \$) will be driven largely by FX gains as the USD is anticipated to decline with the onset of Fed rate cuts, and by the ability of Taiwanese and Indian equities to keep up momentum. While Chinese equities are poised for positive returns following three years of declines, broader concerns linked to structural challenges are likely to influence their attractiveness to investors.

However, downside risks remain. These include the potential for crises triggered by political events, whether of global impact or of local significance. Additionally, there are concerns about the repercussions of China's inability to address its structural economic challenges, and the risk that persistent inflation delays the much-anticipated easing of monetary policies. The recent optimism that allowed some EM central banks to initiate cuts ahead of the Fed could be undermined if (some of) these risks materialize. Such a shift could raise debt-sustainability concerns, push spreads wider and trigger significant outflows, increasing pressure on exchange rates, reminiscent of Q2 2022.

⁴ Broad office price indexes, while a valuable tool for understanding general market trends, may not be a good reflection of the performance of individual portfolios due to idiosyncratic characteristics of the asset class (location, tenant mix, lease terms, condition of the buildings etc.)

A close-up photograph of several hands of different skin tones stacked on top of each other, resting on a tree trunk. The background is a lush green forest with sunlight filtering through the leaves. The text 'Our team' is overlaid on the image.

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