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What to watch: ECB expected on hold again, China ready for new stimulus and high-yield debt on the radar

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In summary

This week, we look at three critical issues:

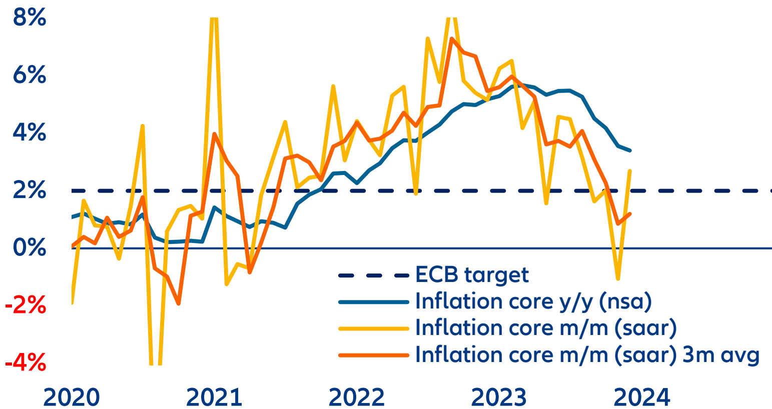
- **ECB expected on hold again and pushing back on early rate cuts.** At its next meeting on 25 January we expect the ECB to keep the deposit rate at a highly restrictive 4.0% for the third time in a row as the disinflation trend continues. Our projection is for a first rate cut in July (-25bps) as the Governing Council shows reluctance to cut rates prematurely, particularly given upside risks from real wage growth – expected at more than 2% annually for around two years – and potential upcoming supply-chain disruptions should the Red Sea crisis last for more than three months, which will push Eurozone inflation above 3%.
- **China: ready for new stimulus.** China's 2023 GDP growth came in at +5.2% as we expected, exceeding the (easy) official target but reflecting weaknesses, including stubbornly low consumer confidence and the real estate slump. Further policy easing is needed in 2024 to restore confidence. We expect GDP growth to muddle through to +4.6% this year. Emerging industries and advanced manufacturing (new energy vehicles, renewable energy, batteries, industrial robots to name the best performing) could become more sustainable growth drivers in the long run, but they are not large enough for now and further development will face challenges.
- **US high-yield debt on the radar.** The US high-yield corporate market is drawing substantial capital, driven by revised policy expectations and a more resilient economic outlook, compressing spreads and raising overvaluation concerns. While corporate fundamentals, rating agency trends and manageable refinancing needs in 2024-25 offer some support, global uncertainty and the high downside risks to the current economic environment should be considered. Our models suggest a modest spread widening in 2024 (~400bps, in line with 2023 levels) but the market should remain appealing for risk-tolerant investors due to relatively high yields.

ECB expected on hold again with a push back on early rate cuts

The ECB will stay on hold again next week, reemphasizing data dependence and pushing back on early rate cuts. The ECB is expected to maintain the status quo at its next meeting on 25 January, holding the deposit rate at a historically high 4.0% (MLF: 4.75%, MRO: 4.5%). Quantitative tightening will proceed according to the announcement in December: a passive roll-off of bonds in the APP program at an average pace of around EUR25bn per month and an additional EUR7.5bn from the PEPP program starting in July.

Disinflation continues in line with the latest ECB staff projections despite the uptick of headline inflation in December from 2.4% y/y to 2.9% y/y. Monthly core CPI, which excludes energy and food components and is not influenced by base effects, accelerated slightly in December, but the three-month average remained below the ECB target for the second month in a row (Figure 1). Having said that, inflation risks remain high in both directions. On the downside, the risk of a stronger recession remains as economic weakness from Germany could spread via the trade channel, with Germany being by far the biggest export partner of other big Eurozone economies such as France and Italy. Secondly, leading indicators such as credit demand and survey data among firms and households still point to a more pronounced recession despite some mild improvement lately. Lastly, ECB estimates suggest that it can take three to four quarters for the full impact of monetary policy to manifest. Hence, around 100bps of the total of 450bps in rate hikes in this tightening cycle have not yet been fully digested by the economy.

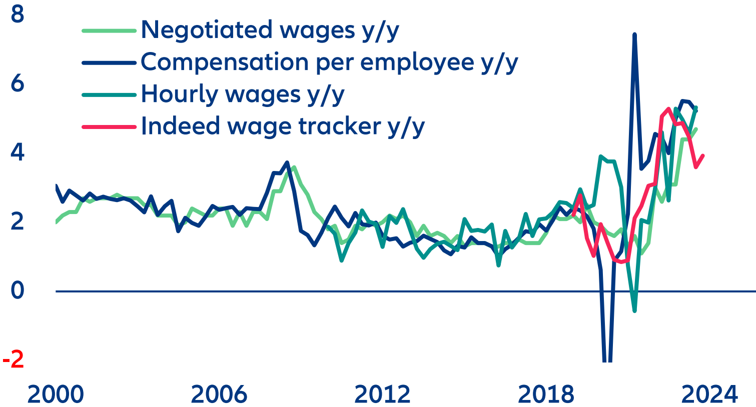
Figure 1: Core inflation y/y and m/m seasonal adjusted, annualized (saar)



Sources: LSEG Datastream, Allianz Research

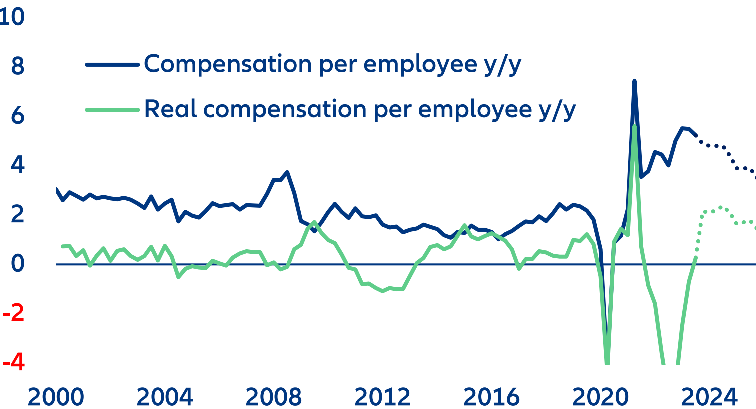
Upside risks to inflation remain, with all eyes on wage growth and possible supply disruptions due to maritime trade blockages in the Red Sea. As maritime traffic now largely avoids the Suez Canal route from Asia to Europe, worries about potential supply-chain disruptions and a repetition of inflation driven by a negative supply shock are on the rise (see last week's analysis on the Red Sea crisis). On the wage front, the latest data points confirm that the peak in nominal wage growth has been reached. Compensation per employee in the Eurozone decelerated to 5.2% y/y in Q3 2023 from 5.5% earlier. However, the more up-to-date Indeed-wage-tracker, closely watched by the ECB, has not decelerated further lately and has hovered around still elevated levels of 3.7-3.9% over the past three months (Figure 2). As inflation has fallen, the major concern is now that rising real wages could reinitiate demand-driven inflation. Given our forecasts for nominal wage growth and inflation – which are close to the ECB's forecast – real wages will rise by more than 2% annually for around two years – a pace rarely seen for such an extended period in the history of the Eurozone (Figure 3). While this is good news for sluggish consumption and growth in the Eurozone, there is a risk that rising demand could lead to upward pressures on inflation. Nevertheless, we do not see an uncontrolled wage-price spiral ahead as real wage levels will only reach pre-pandemic levels at the end of 2024 after having dropped strongly by more than 5% against the backdrop of double-digit inflation rates in 2022.

Figure 2: Nominal Eurozone wage growth in %



Sources: LSEG Datastream, Indeed, Allianz Research

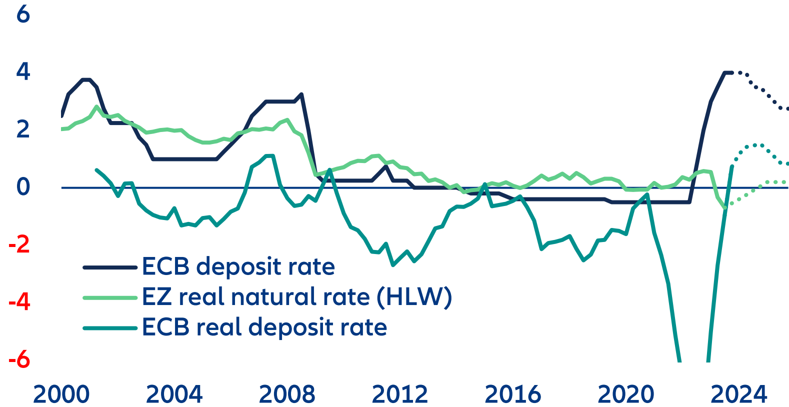
Figure 3: Real Eurozone wage growth in % and Allianz forecasts



Sources: LSEG Datastream, Allianz Research

Going forward, we stick to our call of two 25bps rate cuts by the ECB in July and September as inflation gets closer to the central bank's target and the negative output gap widens. As growth is expected to rebound in the second half this year, buoyed by rising real wages and a return to potential output, the ECB will most likely pause and wait until the inflation target has been met on a sustainable basis (not expected before Q1 2025). Only then will it continue with another 75bps of rate cuts in 2025. This call is more conservative compared to that of the markets, which are currently pricing 130bps and 40bps of cuts in 2024 and 2025, respectively. We admit that market pricing makes sense from the point of view that the ECB is likely to overtighten if it follows our more hawkish outlook. In this case, the real policy rate will be above the estimated neutral rate for an extended period, which has never been the case before in the Eurozone (Figure 4). However, we think that the ECB will be highly reluctant to cut rates too early and too fast in order to avoid being bitten twice by inflation. Several ECB officials such as Lagarde, Lane, Nagel and Villeroy have confirmed this view in recent days.

Figure 4: ECB policy rate, real and nominal

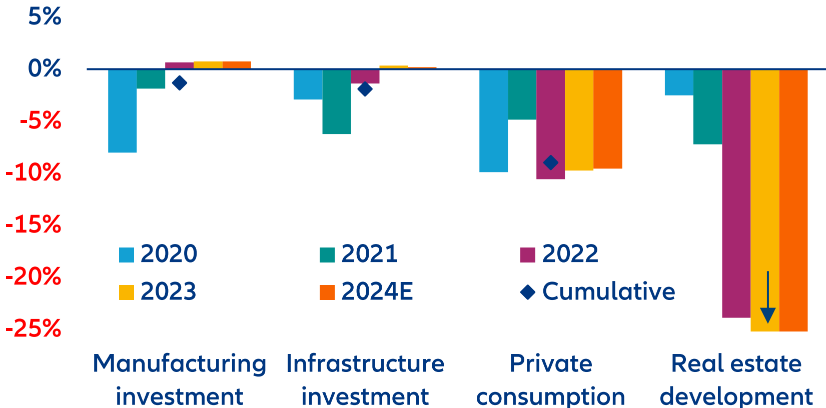


Sources: LSEG Datastream, Allianz Research. Note: HLW refers to the Holsten-Laubach-Williams estimate of a real natural rate at which monetary policy is neither stimulating nor constraining.

China: ready for new stimulus

China's 2023 GDP growth came in at +5.2% as we expected, exceeding the (easy) official target but reflecting weaknesses. Last year started with hopes of a consumer-led rebound[1], which were quickly cut short after Q1 in the context of the property sector continuing to plummet and stubbornly weak confidence. Consumer confidence has not really recovered from the lows of the 2022 lockdowns (at 87.1 on average between April and November 2023, after 93.6 in Q1 2023 and 87.2 over April-December 2022), while business confidence and hiring intentions are not sufficiently buoyant (CKGSB Business conditions index at 47.8 in December 2023 vs. pre-pandemic average of 55.9 and Recruitment index at 55.2 in December 2023 vs. pre-pandemic average of 68.1). In this context, household disposable income grew by a modest +6.1% y/y in real terms in 2023. Although higher than overall GDP growth, this is lower than 2021 (+8.1%) or the pre-pandemic average (+6.7% on average over 2015-2019). Retail sales slowed to +7.4% y/y in December 2023 (vs. +10.1% the previous month) on softening sales of autos and home appliances (though catering held up better). We estimate that private consumption in nominal terms stood nearly -10% below the pre-pandemic trend in 2023 – roughly back to the gap observed in 2020. In comparison, manufacturing and infrastructure investment performed better last year (Figure 5).

Figure 5: Distance to pre-pandemic trend, yearly (%)



[1] *Though expectations were not as high as the last post-zero-Covid year that was 2021, when GDP grew by +8.1%.*

Sources: national statistics, Allianz Research

Further policy easing is needed in 2024 to restore confidence. We expect GDP growth to muddle through to +4.6% this year. Infrastructure investment has been supported by fiscal policy as local governments were given more funding leeway. Going into 2024, we expect the local government special bonds quota to be stepped up to RMB4.2trn (from RMB3.8trn), while long-term special bonds amounting to RMB1trn could be issued by the central government[2]. Supportive monetary policy will help facilitate such issuances. The monetary stance has clearly turned to easing in the second half of 2023 (as illustrated by the credit impulse on Figure 6a), though credit efficiency has been low since 2022 (see Figure 6b). This means that more easing and credit is needed to achieve units of GDP. In 2024, we expect two policy rate cuts (-20bps in total), accompanied by the release of long-term liquidity through two reserve requirement ratio cuts (-50bps in total). The context of the US Federal Reserve pivoting[3] should enable such easing, alleviating pressure on the USDCNY (which has in the past influenced domestic confidence in China). Finally, to further shore up confidence, policymakers need to target price stabilization in the real estate sector, continuing measures such as relaxing purchasing rules, reducing down payment requirements and mortgage rates. Policy easing should thus provide a buffer to the overall economy, which we expect to grow by +4.6% this year.

Figure 6a: Credit impulse index and breakdown

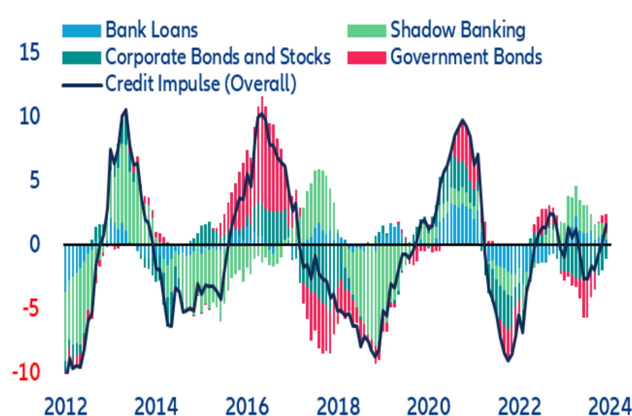
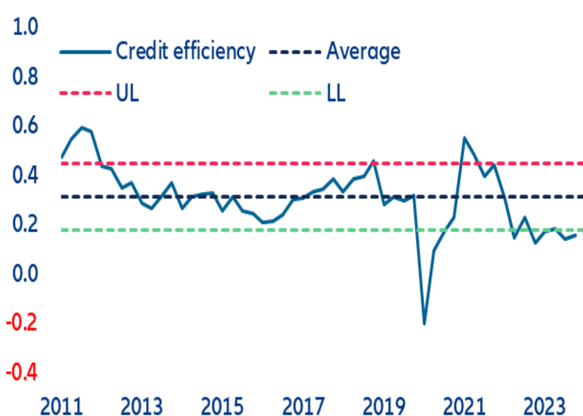


Figure 6b: Credit efficiency



Sources: national statistics, Allianz Research.

Emerging industries and advanced manufacturing could become more sustainable growth drivers in the long run, but they are not large enough for now and further development will face challenges. Despite many weaknesses, 2023 was also the year when China became the largest auto exporter in the world, driven by booming global demand for electric vehicles. Other strategic sectors such as batteries, solar panels and industrial robots also performed very well (see Figure 7). While growing rapidly, for now these emerging industries are not sufficient to make up for the real estate slump. Furthermore, the increasingly tense geopolitical context could bring challenges against further development, both in terms of technological progress and final demand. Chinese policymakers will surely make advanced manufacturing and self-sufficiency part of the long-term growth plan for the economy, but more guidance and communication are needed at this stage. The third plenum[4] was delayed without a date set yet and should define the direction of the Chinese economy for the coming years. The parliamentary "Two Sessions", likely to take place in early March, will reveal the official economic targets for 2024.

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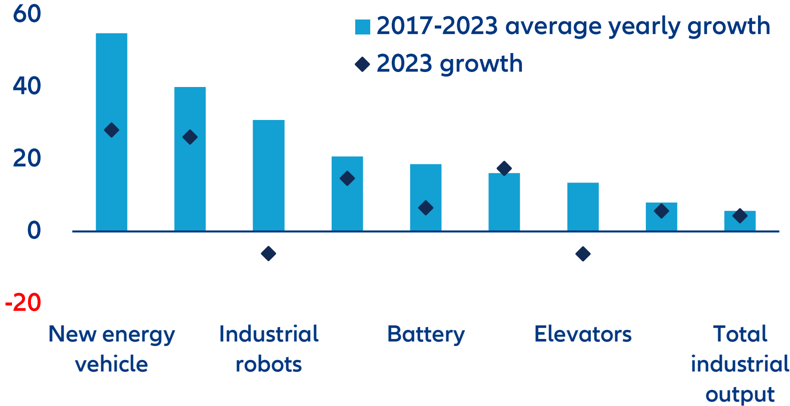
[2] *These are off-budget very long-term central government bonds, aimed at funding projected related to strategically important supply chains. This special tool was last used for pandemic response measures in 2020.*

[3] *We expect the Fed to cut its policy rate four times this year, starting in June and for a total of 100bps.*

[4] *Third plenum of the 20th Central Committee of the Chinese Communist Party. Such plenums take place every five years and usually in autumn.*

Figure 7: Emerging industries with consistently strong performance since 2017 (%)

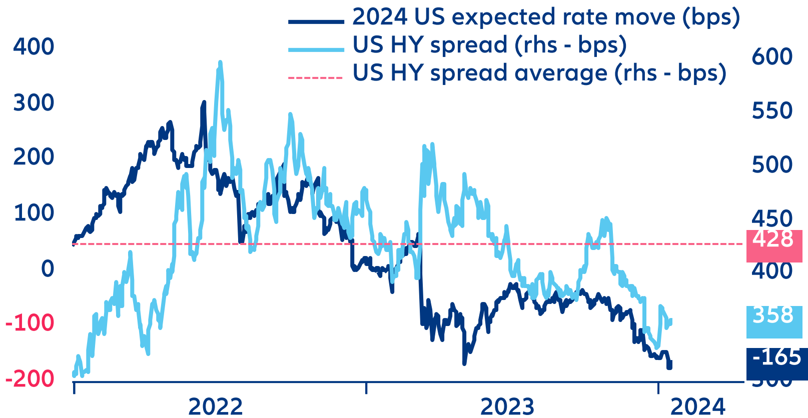


Note: these products are those for which industrial output has grown faster than overall industrial output for five years out of the seven since 2017.
Sources: national statistics, Allianz Research

US high-yield debt on the radar

US high-yield corporate markets are experiencing an impressive influx of fresh capital, defying the less-than-ideal economic and monetary backdrop. The substantial recalibration of policy cuts slated for 2024 and 2025 (Figure 8), promising reduced financing expenses down the road, coupled with the surprising resilience of the US economy have ignited a fresh wave of confidence among investors. This has compressed spreads, though yields remain elevated. Nevertheless, caution is warranted as the exuberance has pushed spreads well below their historical averages to pricing levels typically associated with an environment conducive to economic growth, which seems far from reality as of today.

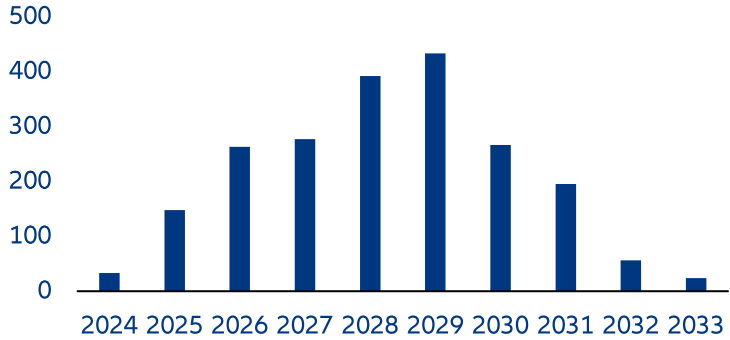
Figure 8: High-yield spreads and US Fed Funds rate policy expectations



Sources: LSEG Datastream, Allianz Research

The prevailing optimism appears to have some solid foundations... Firstly, despite a noticeable decline, corporate fundamentals remain elevated compared to historical levels, suggesting there may still be some flexibility to navigate potential economic challenges. Secondly, the prevailing trend among rating agencies leans towards more upgrades than downgrades, which is bolstering investor confidence. Thirdly, the looming refinancing hurdle appears relatively manageable in both 2024 and 2025, implying that the urgency to address refinancing needs might become a post-2025 narrative. Lastly, while US corporate defaults are increasing, they remain at reasonable levels (Figure 9).

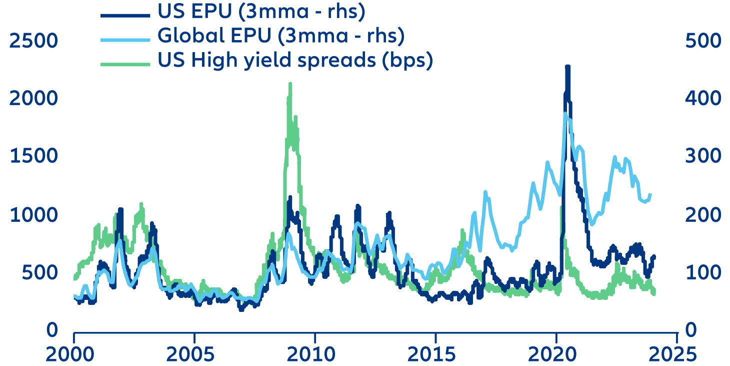
Figure 9: US high-yield corporate credit maturity (in USD bn)



Sources: LSEG Datastream, Allianz Research. Note: maturities longer than 2033 and perpetuals are excluded.

...but global uncertainty remains very high. This underscores the importance of not solely focusing on domestic factors within the US as the risk of an external event originating outside the US significantly impacting the asset class remains a very real possibility, as highlighted by the economic policy uncertainty index (Figure 10).

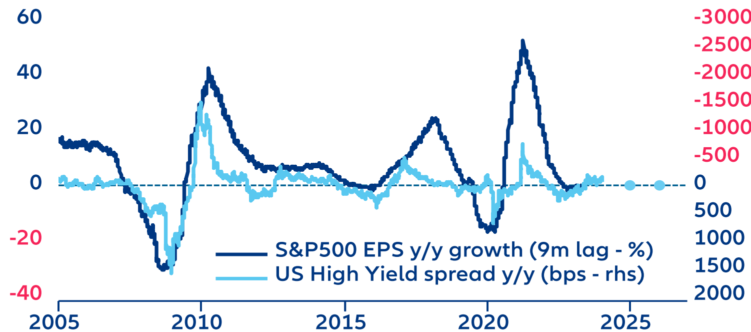
Figure 10: US high-yield corporate spreads and Economic Policy Uncertainty (EPU)



Sources: LSEG Datastream, Allianz Research

Looking ahead, we anticipate a modest widening of high-yield spreads in the near future. The current pricing seems to be overestimating the resilience of high-yield issuers amidst the prevailing economic and geopolitical challenges. In this context, the upcoming earnings season should reveal whether the optimism can last. The key factors to watch will be the resilience of companies' growth engines and the extent to which consumers can maintain their current level of consumption or savings depletion. This dynamic is likely to lead to increased disparities at the individual issuer level within the high-yield space. Nevertheless, we do not anticipate abrupt price fluctuations and the current yield levels should remain appealing to investors comfortable with the associated risk. We continue to expect high-yield spreads to finish 2024 at around 400bps and to mildly compress thereafter (Figure 11).

Figure 11: US high-yield corporate spreads and earnings growth



Sources: LSEG Datastream, Allianz Research

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