04 There is no such thing as a soft landing

10 US: headed towards a crash landing

13 Eurozone: stagnation ahead

23 China: the reopening is paying off, but risks remain

25 Emerging markets: the head is still on

30 Capital markets: it´s the banks... again!

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Everything everywhere all at once

Executive Summary

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Negative confidence effects from the near-death experience in the US banking sector and the unresolved energy situation in Europe will shape the rest of the year. We maintain our call for a sizable recession in the US at the end of the year due to a slowdown in housing, manufacturing and construction, while economic momentum stalls in the Eurozone as fiscal stimulus is gradually pared back. The outlook for the Chinese economy has improved, but global spillovers from the reopening are limited. We expect global growth to slow to +2.2% in 2023, and to recover very modestly to +2.3% in 2024. Barring the US, Germany, Italy and UK, other large advanced economies will manage to avoid recessions but emerging markets, and commodity importers in particular, will generally remain under pressure due to rising internal and external imbalances. Low demand will keep the manufacturing sector in recession in 2023 due to consumers' deteriorating purchasing power and a longer replacement cycle of durable goods. At the same time, oversupply is likely to persist well into this year, deflating the cost of traded goods. In this context, delivery times are normalizing and shipping costs are also nearing their pre-pandemic levels. Global trade in goods and services is likely to grow by only +0.9% in volume terms in 2023 (down from +3.7% in 2022) and to contract by -0.3% in value terms (down from +9.6% in 2022).

Central banks remain ever more caught between a rock and a hard place: financial stability concerns could complicate the already difficult trade-off between managing sticky core inflation and maintaining growth in setting policy rates over the next few months. Resolving this dilemma could prolong the fight against inflation unless slowing demand is sufficiently disinflationary to allow central banks to tread more carefully. We expect inflation to noticeably decelerate over the coming quarters and average 6.6% at the global level this year before receding to 4.0% in 2024. Given sticky core inflation, we expect central banks to take a more measured approach to further rate hikes, striking a balance between maintaining a restrictive monetary stance and acknowledging growing vulnerabilities in the financial sector, especially if an inverted yield curve is tacitly accepted to allow banks to better manage down their rising duration gaps.

Restoring confidence in the financial system and persistent energy uncertainty could delay fiscal adjustment this year to give more flexibility to monetary policy. After most countries have taken bold steps to cushion the impact of the energy crisis, fiscal space is now much more constrained amid rising interest rates. However, concerns about financial stability might require governments to prioritize bolstering the safety net, including by providing public debt guarantees and backstops to crisis resolution mechanisms and raising the coverage of deposit insurance. While such fiscal support could help central banks keep interest rates high to stymie inflation without being constrained by banking sector vulnerabilities, rising interest-rate burdens challenge debt sustainability. In particular, diminishing fiscal space could require difficult policy trade-offs as governments also tackle important structural challenges outside the current energy and banking crisis, such as the green transition of their economies and the launch of bold pension reforms, such as in France and Spain.

The evolving banking sector turmoil will shape the capital markets outlook. While potential contagion effects of bank failures in the US and the rescue of Credit Suisse have been averted, possible dislocations could arise from considerable vulnerabilities to unrealized losses from a deeper correction in real estate and the re-pricing of private debt exposures. More critically, financing conditions are bound to tighten further as banks raise lending standards and safeguard their capital and liquidity buffers, further retrenching credit, with potential spillover effects for market liquidity. Given the current uncertainty about the central banks' policy rate path, the first half of 2023 will most likely follow the current volatile market dynamics. Despite expected economic and policy tailwinds towards the end of the year, the rebounding momentum will be delayed into 2024. In this environment, we expect the long-end of the sovereign curves to range trade for the remainder of the year around current values, with some upside risks in the short-run and some downside in the second half of the year. Equities are very likely to finish the year on a mildly positive note, while the jury is still out on corporate credit, with credit risk making a comeback in 2023, especially in lower-rated buckets.

What could go wrong? While the financial sector has not reached full-blown crisis mode, further bank failures and capital market disruptions cannot be ruled out as policymakers struggle to restore investor confidence. In Europe, more energy-supply constraints, for instance as a result of colder weather towards the end of the year, could require gas rationing, which would push 2023 GDP growth into negative territory; this scenario could be further exacerbated if the war in Ukraine escalates. In addition, higher-for-longer inflation increases the risk of a policy mistake by central banks, especially in the US, whose data-driven approach underestimates the lagged impact of rate hikes on aggregate demand and risks of a deeper and prolonged economic downturn. On the other hand, avoiding further dislocations in the financial sector by shoring up public confidence would boost investment and growth while allowing central banks to effectively manage inflationary pressures. In addition, a ceasefire in the war in Ukraine could release some market pressure and supply constraints, while China's reopening could revitalize slowing global trade and accelerate the decline of producer prices. Last, geo-economic confrontations, sanctions, trade wars and investment screening in the name of national security pose risks to economies worldwide, with unintended widespread spillover effects.

Photo by John McArthur on Unsplash

There is no such thing as a soft landing

The combined effect of tighter monetary policy, the unsolved energy crisis, and the near-death experience in the US banking sector will shape the outlook for this year (Tables 1 and 2). The continued uncertainty about gas supply during the second half of the year as well as high electricity and food prices will weigh on consumer sentiment and business prospects on the back of declining corporate profits and households' real incomes, resulting in a stop-and-go growth momentum. We have slightly raised our growth projections for some major economies compared to the last forecast, but we still expect global growth to slow in 2023, with increasing drag from cumulative monetary policy tightening on economic activity and employment. We project a sizeable recession in the US ("hard landing") at the end of the year due to increasingly entrenched negative confidence effects, with a slowdown in housing, manufacturing and construction as interest rate hikes further increase borrowing costs and dampen investment. These factors will also cause the Eurozone economy to stall early this year (with mild technical recessions in Germany and Italy) as fiscal stimulus is pared back during the second half of 2023. We expect a subdued recovery in 2024, especially in Europe, where financing conditions are likely to remain tighter for longer. Global growth is likely to slow to +2.2% and to recover very modestly to +2.3% in 2024, with significant divergence between advanced and emerging market (EM) countries. Although the US and the UK will go through recessions (i.e. two consecutive quarters of negative growth), advanced economies overall will avoid negative growth figures in 2023 (+1.1% in the US, +0.3% in the Eurozone) and 2024 (+0.4% in the

US, +0.9% in the Eurozone) (Figure 1). Pressures on EMs are likely to keep building due to rising internal and external imbalances, especially for commodity importers. Growth is expected to rebound in Asia-Pacific in 2023 at +4.1% and slightly accelerate in 2024 to +4.3%, supported by China's faster-than-expected reopening. However, it will slow down in Eastern Europe, the Middle East and Latin America in 2023 to +0.9%, +2.7% and +1.5%, respectively, before rebounding in 2024.

Table 1: Global growth

Growth (yearly %)	2020	2021	2022f	2023f	2024f
Global	**-3.3**	**5.9**	**3.0**	**2.2**	**2.3**
USA	**-2.8**	**6.0**	**2.1**	**1.1**	**0.4**
Latin America	**-7.1**	**6.8**	**3.7**	**1.5**	**1.9**
Brazil	-4.2	5.3	2.9	1.0	1.2
UK	**-11.0**	**7.6**	**4.1**	**-0.3**	**0.6**
Eurozone	**-6.3**	**5.3**	**3.5**	**0.3**	**0.9**
Germany	-4.1	2.6	1.9	-0.1	0.8
France	-7.9	6.8	2.6	0.4	0.8
Italy	-9.1	6.7	3.8	0.3	0.7
Spain	-11.3	5.5	5.5	1.0	1.0
Russia	-2.7	4.7	-2.3	-1.0	1.3
Turkey	1.9	11.4	5.6	3.1	3.8
Central and Eastern Europe	**-3.3**	**5.9**	**2.5**	**0.9**	**2.6**
Poland	-2.0	6.8	6.8	0.9	2.6
Asia-Pacific	**-1.0**	**6.2**	**3.3**	**4.1**	**4.3**
China	2.2	8.1	3.0	5.0	4.8
Japan	-4.7	2.2	1.1	1.0	1.2
India	-6.6	8.3	6.9	5.7	6.2
Middle East	**-4.2**	**4.0**	**6.0**	**3.2**	**2.7**
Saudi Arabia	-4.1	3.9	3.9	4.1	3.2
Africa	**-1.7**	**5.8**	**3.4**	**3.2**	**3.4**
South Africa	-6.3	4.9	2.5	0.7	1.4

Source: Allianz Research

Table 2: Global inflation

Inflation (yearly %)	2020	2021	2022f	2023f	2024f
Global	**2.6**	**4.3**	**8.6**	**6.6**	**4.0**
USA	**1.3**	**4.7**	**8.0**	**4.6**	**2.2**
Latin America	**11.8**	**13.9**	**14.9**	**15.6**	**10.9**
Brazil	3.2	8.3	9.3	5.6	3.9
UK	**0.9**	**2.6**	**9.1**	**6.5**	**3.4**
Eurozone	**0.3**	**2.6**	**8.4**	**5.6**	**2.6**
Germany	0.5	3.1	7.9	5.6	2.8
France	0.5	1.6	5.2	5.2	2.6
Italy	-0.1	1.9	8.2	5.9	2.2
Spain	-0.3	3.1	8.4	4.8	3.5
Russia	3.4	6.7	13.8	12.0	7.4
Turkey	12.3	19.6	72.3	40.9	23.9
Central and Eastern Europe	**4.5**	**8.1**	**9.1**	**11.7**	**5.9**
Poland	3.4	5.1	14.4	11.4	5.8
Asia-Pacific	**2.2**	**1.7**	**3.7**	**3.4**	**2.7**
China	2.5	0.9	2.0	2.4	2.3
Japan	-0.0	-0.2	2.5	2.2	1.5
India	6.6	5.1	6.7	5.5	4.6
Middle East	**9.9**	**15.8**	**16.8**	**21.1**	**12.9**
Saudi Arabia	3.5	3.1	2.5	2.7	2.1
Africa	**10.0**	**12.4**	**13.4**	**14.5**	**8.8**
South Africa	3.3	4.6	6.7	5.1	4.7

Source: Allianz Research

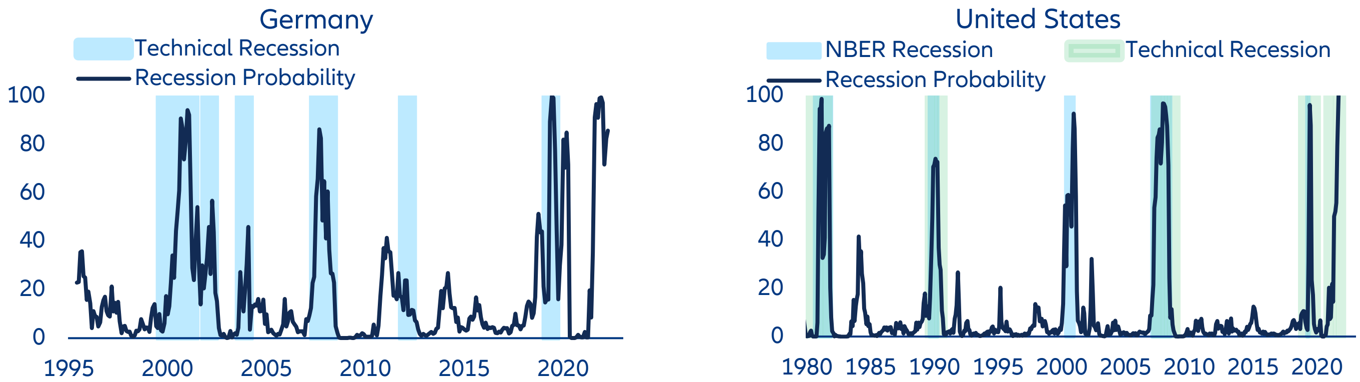
Solid labor-market dynamics to slow down as the economic outlook remains gloomy. The labor market is, at best, a coincident indicator of the business cycle. In the US, the historical record shows that the economy still continues to create jobs at a healthy clip just at the onset of a recession, before shedding jobs for the following 12 months. Consistent with our recession call, we expect payrolls to start declining from Q4 2023 and the unemployment rate to tick up coincidentally. However, despite our expectation of a sizeable negative output gap in end 2023-early 2024, we are penciling in only a modest rise in the unemployment rate, from 3.6% in Q1 2023 to a peak of 4.8% in Q1 2024. In the Eurozone, the labor market proved resilient both through the pandemic and energy crises, with the unemployment rate stable for the third consecutive month at a historic low of 6.7% in January 2023. The prolonged challenges affecting the region will result in a slight deterioration of employment conditions: We forecast a mild increase in the unemployment rate from 6.7% in 2022 to 7.2% in 2023.[1]

Slowing global demand and manufacturing oversupply mean that we continue to expect a sharp slowdown in global trade in 2023. We forecast global trade in goods and services to grow by merely +0.9% in 2023 in volume terms (after +3.7% in 2022), and contract by -0.3% in value terms (after +9.6% in 2022). A recovery is likely in 2024, with +3.9% expected in volume terms and +4.7% in value terms. Global demand is slowing in a context of stagnation or recession in developed markets, consumers' deteriorating purchasing power and the lengthening replacement cycle of durable goods. The improved outlook for the Chinese economy is not sufficient to make up for these pressures, creating just USD80bn of additional export gains this year, according to our estimates (i.e. less than 0.3% of global trade). Meanwhile, the trend of slowing demand comes in a context of increased production capacity and replenished inventories in the manufacturing sector. This situation of oversupply, which started to emerge in the second half of last year and is likely to persist in 2023,

[1] Our benign scenario for the labor market assumes a record number of unfilled job vacancies and widespread labor shortages in both the US and Europe. In the US, for instance, the vacancy-to-unemployed ratio is close to 2; in Germany, France and Italy, vacancy rates remain above pre-pandemic levels. In the face of weakening demand, companies will reduce these job openings rather than laying off employees. Furthermore, many businesses will probably opt for "labor hoarding strategies", reducing working hours rather than laying off workers, which will reduce overall labor productivity.

helps to unlock the shortage situations observed in 2021-2022 and deflate the cost of traded goods (that had sometimes reached record highs). China's reopening also reduces the risk of sudden stops in global supply chains. In this context, delivery times are normalizing and shipping costs are also nearing their pre-pandemic levels. While cyclical conditions have reduced supply-chain disruptions, we may not be fully rid of the risk of shortages in the medium-term. Even though deglobalization and decoupling are not part of our central scenario, continued geopolitical tensions and protectionism could potentially affect the availability of certain traded goods (e.g. US ban on semiconductor exports to China and China's ban on the export of technology used to make solar panels).

Figure 1: Recession probability (March 2022) (%)



Sources: Refinitiv Datastream, Allianz Research. Note: based a logarithmic regression of four factors - avg. weekly hours worked, ISM new orders, government debt yield curve steepness (10Y-2Y), and consumer expectations.

The balance of risks remains tilted to the downside. While the financial sector has not reached full-blown crisis mode, further bank failures cannot be ruled out as policymakers struggle to restore investor confidence. To add to this, more energy-supply constraints, for instance as a result of colder end of the year, would require gas rationing in Europe, which would push 2023 GDP growth into negative territory. Higher-for-longer inflation also increases the risk of a policy mistake by central banks. US monetary tightening and overshooting particularly by the Fed hold the risk of a deeper and prolonged economic downturn. The consequences of bank runs amidst inflation and tightening credit conditions could have even broader effects. However, avoiding further dislocations in the financial sector by shoring up public confidence would boost investment and. Central banks will reach their terminal rates by moving more steadily while keeping a tight monetary stance as the better outlook favors more persistent domestic inflationary pressures. A ceasefire would indeed release some of the market pressure as well as supply constraints. The shift in China's containment measures could also lead to positive re-opening effects that could revitalize slowing global trade and accelerate the decline of producer prices, which had reached record levels only a few months ago.

Restoring confidence in the financial system and persistent energy uncertainty could delay fiscal adjustment this year to give more flexibility to monetary policy. After most countries have taken bold steps to cushion the impact of the energy crisis, fiscal space is now much more constrained amid rising interest rates. However, concerns about financial stability might require governments to prioritize bolstering the safety net, including by providing public debt guarantees and backstops to crisis resolution mechanisms and raising the coverage of deposit insurance. While such fiscal support could help central banks keep interest rates high to stymie inflation without being constrained by banking sector vulnerabilities, rising interest-rate burdens challenge debt sustainability. In particular, diminishing fiscal space could require difficult policy trade-offs as governments also tackle important structural challenges outside the current energy and banking crisis, such as the green transition of their economies and the launch of bold pension reforms, such as in France and Spain.

Looking beyond the current macro-financial challenges, risks to fundamental needs such as food, energy and security will be at center stage for the years to come. While an overhang in economic and health conditions from the global pandemic, Russia's war against Ukraine and sanctions that impact the globally integrated economy amplify these risks, which will be here to stay. The looming threat of Russia pulling out of the Black Sea Grain Export Deal adds significant volatility on the price of core necessities. President Putin is extremely under pressure as the ripple effects from the invasion of Ukraine have cut Russia nearly completely off from advanced industrial democracies. This has implications for regional and global security alike, as well as for firms' access to key commodities, such as oil, gas and critical materials.

The resilience of global supply chains remains to be tested – particularly as the recent reopening of China puts further pressure on energy and commodity prices. China has put itself on the global diplomatic center stage (cp. Iran-Saudi Arabia agreement, Russia-Ukraine ceasefire plan) but poses another imperative in a more unstable world. China's policy decisions remain difficult to predict, with increasingly important involvement of the party. Moreover, China's long-term economic slowdown and continued tensions in the East China Sea have implications for both Taiwan's crucial global role in the manufacture of semiconductors and global trade relationships with China. A confrontation between China and the US seems even more likely or inevitable unless the US changes its policy trajectory.

Geo-economic confrontations, sanctions, trade wars and investment screening in the name of national security pose risks to economies worldwide, with unintended widespread spillover effects. They may create a vicious and escalating cycle of distrust and even spur contrary outcomes. In such an environment, multinational companies face reputational and legal risks, but governments might even unintentionally create a business environment where firms are more strongly exposed to geographically concentrated problems (i.e. labor shortages, civil unrest or the consequences of natural weather events).

With respect to elections, the Turkish and Spanish are the key votes to watch in 2023. In Turkey, the president is running for re-election, but the outcome looks uncertain and could lead to a second round. Large-scale political unrest may occur, especially in the case of a tight race, allegations of vote rigging or refusal to acknowledge defeat. In Spain, the support for the right-wing Peoples Party (PP) surged sharply in the first quarter of 2023 and it might win the largest vote share. To form a government, PP could need support from the far-right conservative Vox, which would make Spain the third country in Europe to include a far-right party in the government after Italy and Sweden. Poland and Greece are other important elections to keep an eye on. In Greece, the centre-right New Democracy (ND) will struggle to secure a parliamentary majority due to changes to the electoral rules. This might cause political instability and a snap election. In Poland, the Law and Justice (PiS) party will likely remain the strongest political power, but the liberal democratic opposition might secure enough votes to gain a majority in parliament. This might help to improve relations with the EU, which have deteriorated significantly under PiS-led governments. South-Eastern Europe faces various elections in 2023, including likely snap elections in Montenegro and Bulgaria. The region is particularly vulnerable to political instability, given its limited ability to absorb shocks, public discontent and low institutional effectiveness.

Photo by Christian Lue on Unsplash

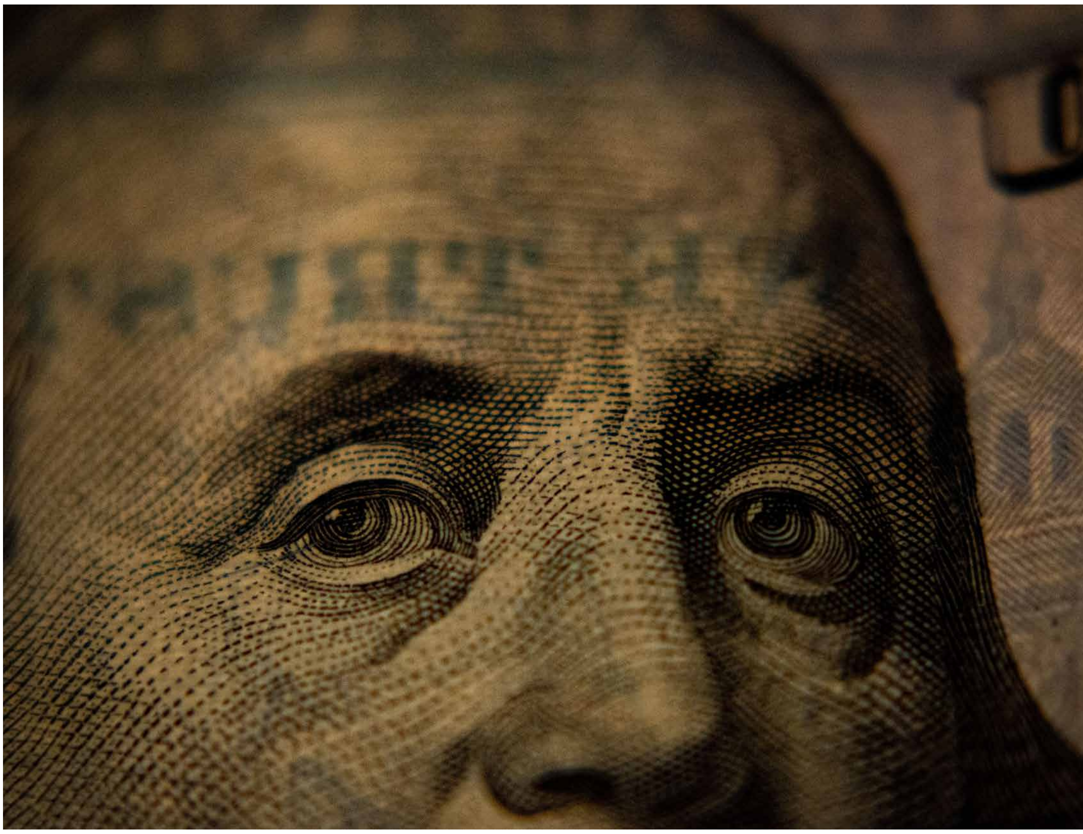


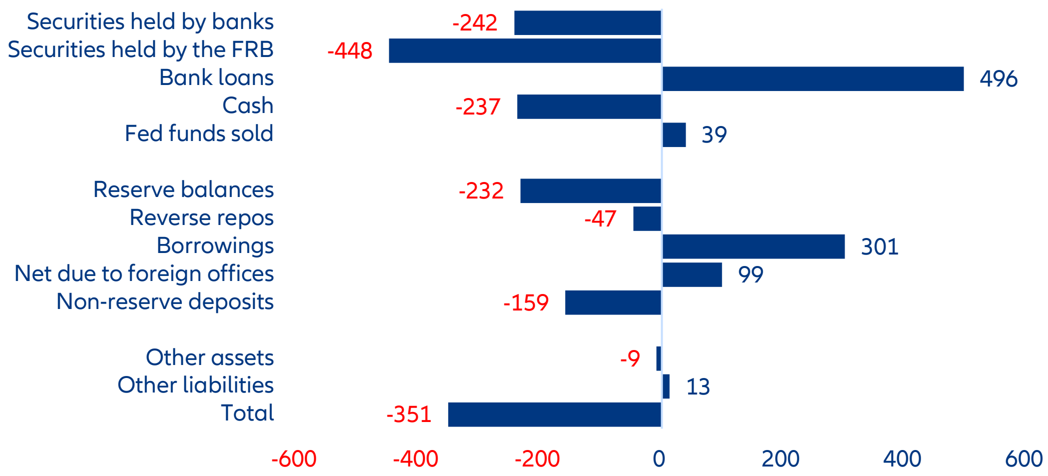
Photo by Adam Nir on Unsplash

US: headed towards a crash landing

The US economy picked up pace in early 2023, but we expect this revival to be short-lived. High-frequency indicators such as retail sales, industrial production and core capital-goods orders bounced back during the first quarter of 2023. The labor market also regained some strength, with the net creation of 800K jobs until the end of February. This 'mini' cyclical revival is, for the most part, down to accelerating household spending. The latter has been fueled by a rapid pick-up in credit card debt, increased social security payments, a lower effective personal income-tax rate and a low savings rate. On the corporate side, businesses have continued to build up inventories to insulate themselves against future shortages. Industrial firms are still working through a large backlog of previous orders. In this environment, price and wage pressures have remained uncomfortably elevated. According to the NFIB survey, small corporates still plan to grant hefty compensation hikes for the remainder of 2023, while month-on-month underlying CPI inflation has not eased on a sequential basis.

We expect the economic momentum to deteriorate during the second half of the year on the back of rapidly tightening credit conditions, exacerbated by the banking crisis. We are penciling in a recession of -1% between mid-2023 and end-2023. Monetary policy operates with long lags and most forward-looking indicators point to a downturn happening in the second half of 2023. Banks have been curtailing the supply of credit to the private sector, and low confidence in the financial sector will likely make them even more conservative. Corporates' capex plans have never been so low outside of recession periods, while currently declining real house prices should start to weigh on consumer spending before the end of 2023, according to usual lags. The squeeze in aggregate demand that we expect should bring headline inflation very close to the Fed's 2% target by the second quarter of 2024.

Figure 2: Change in US counterparts of M2 money supply (excluding money market funds) between August 2022-February 2023



Sources: Refinitiv Datastream, Allianz Research

The record contraction of US money supply spells doom for financing conditions over the near term (Figure 2). After reaching an all-time high-water mark in March 2022, US money supply (M2) declined by USD472 bn (or -2.2%), which was driven entirely by a shrinking deposit base (-USD720 bn). Over the same period, M1 decreased even more (-5.1%). In post-WWII history, this is a unique event. While credit growth has still held up, a significant decline in bank lending seems inevitable amid the collapse of monetary aggregates. Since November 2022, annualized credit growth has declined to +8.4%. However, at an annualized rate of growth of +12.3% and +16.1%, credit card and real estate loans (especially commercial real estate) are still going strong.

We do not expect fiscal policy to come to the rescue to mitigate the recession. Appetite for fiscal stimulus has waned amongst politicians amid the recognition that inflation was pushed up by lax fiscal spending during the pandemic. We expect Congress lawmakers to agree on a modest fiscal tightening during the summer to solve the debt-ceiling crisis. US states are facing ballooning interest expense bills, alongside the prospect of reduced Federal aid, which will prompt them to consolidate their finances.

Economic resilience – including in the labor market – and stubbornly elevated price pressures mean that the Fed will remain in a hawkish mode despite increased fragility in the banking sector. We expect the Fed Funds rate (FFR) to peak at 5.25% (upper band of the target) in May. Rapidly falling inflation and economic weakness in the second half of the year will prompt the Fed to ease back a little on its very tight stance: we expect a 25bps rate cut in the November 2023 FOMC meeting, followed by a 50bps cut in December. Nevertheless, at 4.5%, the FFR will remain very elevated and still well into restrictive territory. Further rate cuts are to be expected in 2024, with a terminal rate in this cycle reached at 3.25% by mid-2024.

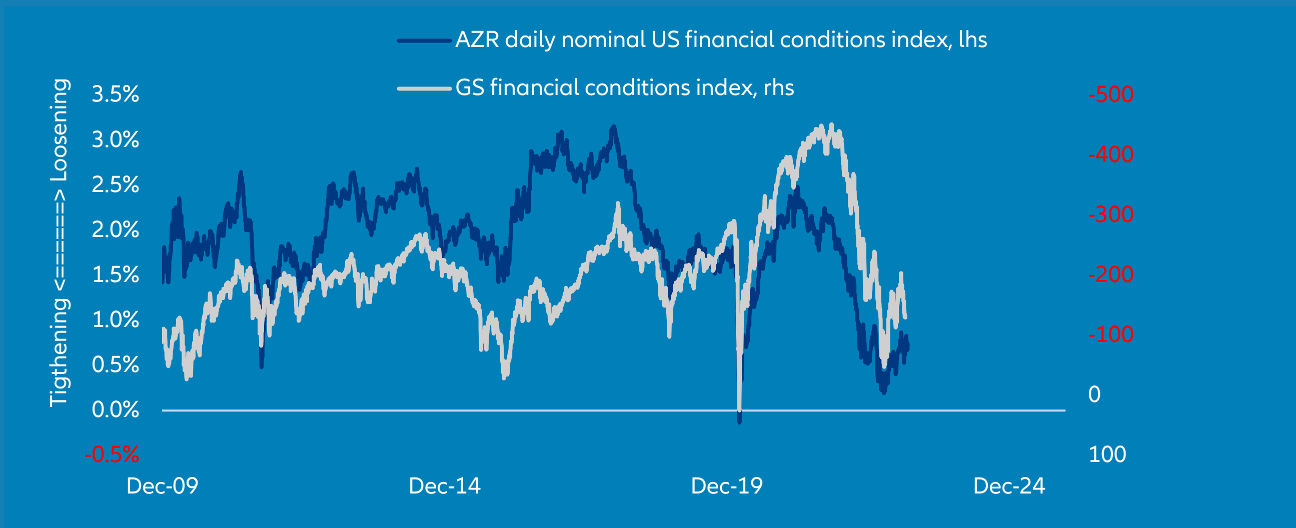
The banking crisis reinforces downside risks to the US housing market through further tightening of mortgage lending standards. As the most interest-rate-sensitive sector of the economy, the housing market has gone through a rapid phase of correction since the summer of 2022. Typical in a housing downturn, transactions and starts have been the first dominos to fall; house prices are declining later in the cycle. Sales of new one-family houses plummeted from a peak of 1,000K (annualized) at the end of the summer 2020 to a trough of 550K in September 2022. Existing-home sales and new private housing starts have not bottomed out yet. While transactions on existing homes should bottom out before long, we expect the downturn in housing starts to have further to run. We expect residential investment to bottom out in Q3 2023, before engineering a modest recovery amid tight credit conditions and still elevated mortgage rates. As per property prices, we are sticking with our long-standing forecast that the inflation-adjusted S&P Shiller-Case index will fall by around -12% to -15% between its May 2022 peak and end-2023, based on leading signals sent by monetary and lending aggregates.

Box 1: Financing conditions index (FCI)

The current discussion about central banks' capacity to resolve the dilemma between price and financial stability requires a firm grasp of how the monetary stance has and will affect financing conditions. Financial conditions indices (FCI) measure the lagged impact of a set of financial variables on the real economy. We develop our own FCI for the US economy, which blends the exponentially weighted returns of five key financial indicators, four of them with positive weights: The S&P 500 (lagged by two quarters); the ICE BofA high-yield total return bond index (lagged by two quarters); the total return of two-year UST relative to one-year UST (lagged by eight quarters) and the Federal Reserve Trade Weighted Nominal Dollar Index (lagged by six quarters). The last one – oil (lagged by four quarters) – has a negative coefficient. The smallest of the lags – two quarters – determines the forecasting horizon. The weights given to each of the five constituents are found by maximizing the ability to predict the y/y rate of growth of US real GDP from October 1984 (when the ICE BofA index was introduced) to the end of 2019. Our FCI has behaved very much like the Goldman Sachs FCI in recent years (Box 1, Figure 1).

We find that during both monetary easing and tightening periods, the return on high-yield corporate bonds was the key driver of changes in financing conditions, followed by oil and the trade-weighted dollar (Box 1, Figure 2). At its current level of +0.8%, our FCI is very close to historical lows: the frequency of lower readings is only 6.5%.

Box 1, Figure 1: US – financial conditions index



Sources: Goldman Sachs, Refinitiv, Allianz Research

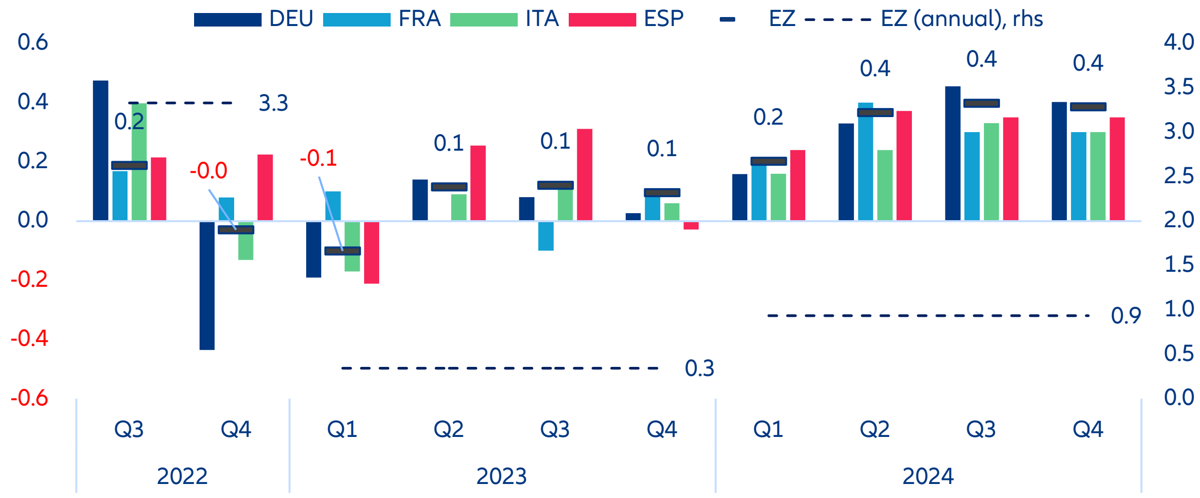
Box 1, Figure 2: US – decomposition of the financial conditions index

Sources: Goldman Sachs, Refinitiv, Allianz Research

Eurozone: stagnation ahead

The Eurozone economy still struggles with high inflation as financing conditions remain tight even as supply-side problems are gradually fading. Weak consumption and investment dynamics, as well as a challenging external environment and declining confidence in light of the recent financial sector turbulence, are the key drivers behind the current downturn. Even though there has been some catch-up production related to easing supply-chain problems, a contracting order book and still negative industrial-survey responses suggest weaker production expectations. For services, recent demand and expected demand weakened in February, though moderately.

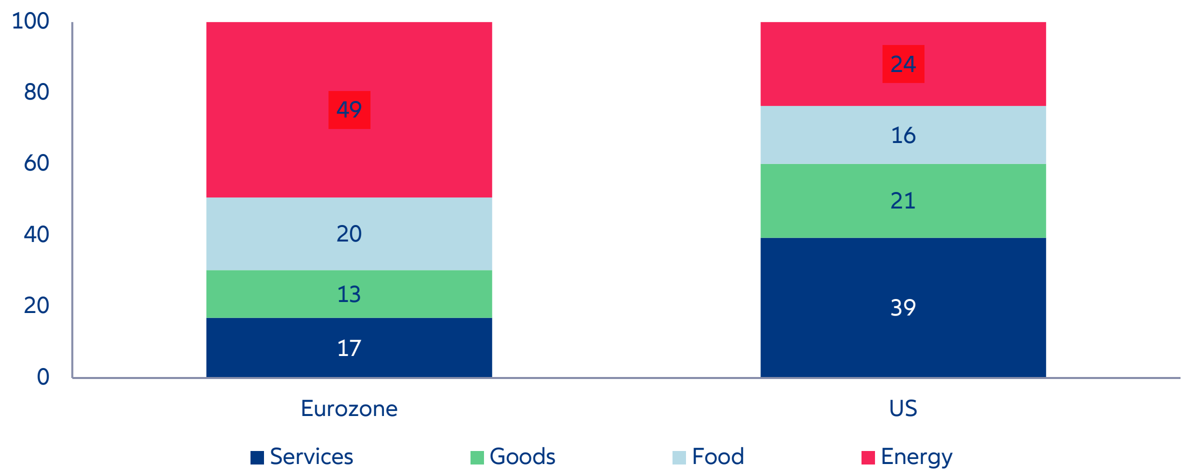
Figure 3: Eurozone: real GDP growth (quarterly, y/y)



Sources: Refinitiv Datastream, Allianz Research

We expect growth to average merely +0.3% this year, followed by a shallow recovery of +0.9% next year (Figure 3). This is an upward revision relative to our last forecast in Q4 2022, which assumed that the impact of the war in Ukraine and high inflation rates on consumption and investment would kick in much earlier than just in Q4 2022. The first quarter of 2023 marks the trough of the downturn on our forecast. Consumers will remain cautious over the coming months amid an elevated cost of living and rising interest rates. The relatively tight labor market and accumulated excess savings have helped cushion the blow from the economic slowdown until now and will provide moderate support to household income and consumption. We expect the current banking stress to weigh on growth primarily via reduced bank lending. Based on the historical relationship between credit growth and bank lending standards relative to our financing conditions index, we find a potential hit to the level of real GDP of up to 0.2%, pointing to a manageable drag on growth from current tensions in the banking sector.

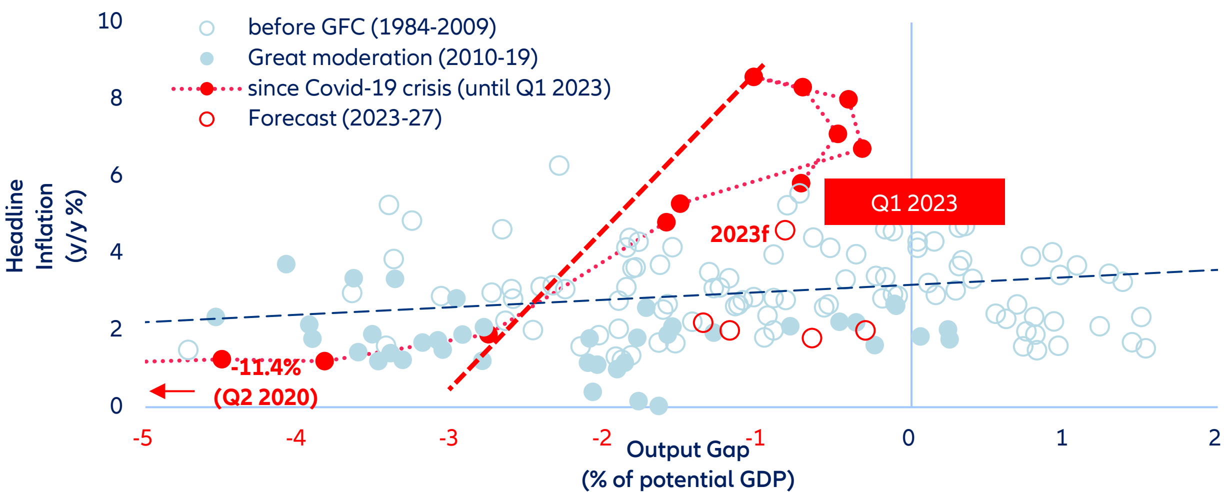
Figure 4: Eurozone and US: composition of headline inflation (y/y %)



Sources: Refinitiv Datastream, Allianz Research. Note: estimates based annual logarithmic differences at quarterly frequency for each inflation component (i.e., difference-in-difference approach).

Even though inflation has slowed over the recent months, largely due to government support measures aimed at capping energy costs, price pressures will stay strong during the first half of this year. We expect governments to increase spending further to mitigate the impact of high electricity costs. However, they will tread carefully as the leakage of poorly targeted measures could slow down the reduction in inflation. Annual inflation still runs above 8% (compared to last year) – that's more than four times the ECB's price stability target of 2%. Headline inflation declined slightly from 8.6% in January to 8.5% in February (with increases in Germany, France and Spain offset by declines in Italy and some smaller countries). However, energy inflation will drop precipitously during the coming quarters (due to strong disinflationary base effects) and represent less than 10% of overall inflation this year (Figure 4). For energy (and food) inflation, base effects are becoming increasingly powerful now, especially in countries where the implementation of price breaks occurred only late last year. Price pressures are shifting to goods and services ("core inflation"). Selling-price expectations show a clear divergence between goods and services, which is key for core inflation developments ahead. We see a strong decline in the indicator for goods-price expectations as easing supply-chain problems and lower energy costs have caused a decline in input-price growth. Services expectations are higher and more influenced by increasing wage costs. We expect headline inflation to average 5.6% this year and 2.6% next year.

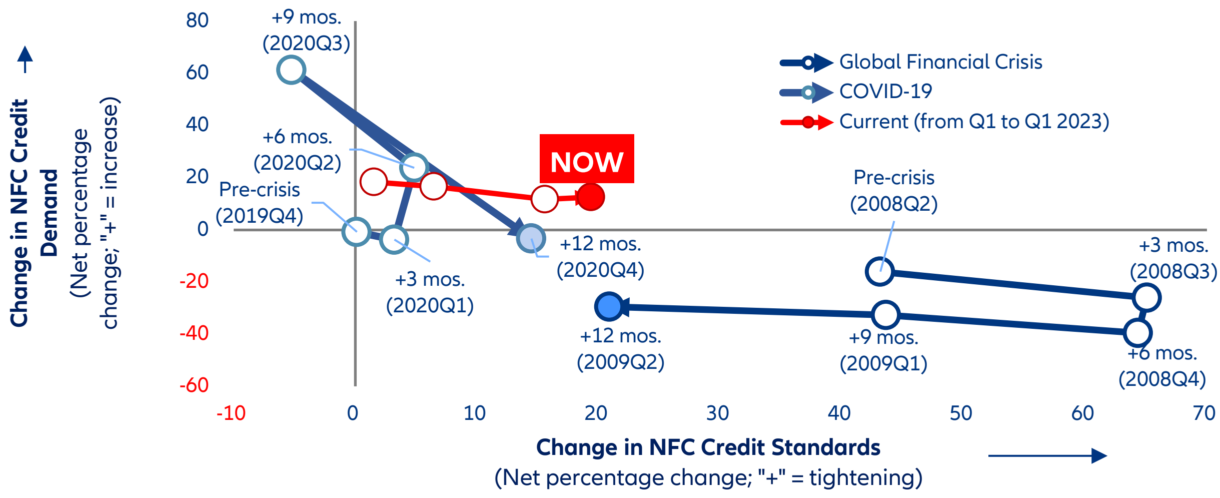
Figure 5: Eurozone – Bank Lending Survey: Factors contributing to change in NFC credit demand



Sources: IMF, Refinitiv Datastream, Allianz Research

Despite declining energy inflation, the negative supply shock to inflation still creates a challenging environment for monetary policy. Since the "divine coincidence" of low inflation during times of slowing growth does not apply, the ECB would need to formulate a forward-guidance on its policy rate path that does not excessively slow aggregate demand (also considering that the economic impact of tighter financing conditions operate with considerable lag) (Figures 5 and 6). In addition, financial-stability concerns related to spillover effects from recent US bank failures to Europe are likely to influence the ECB's monetary stance going forward. However, February's increase in core inflation will reinforce the ECB Governing Council's conviction that significant rate increases are still needed. After the 50bps-hike at the last meeting, we forecast two more 25bps-hikes in May and June for a terminal rate of 3.5%, with the ECB maintaining a restrictive stance in 2023 despite stagnating growth until Q1 2024.

Figure 6: ECB bank lending survey

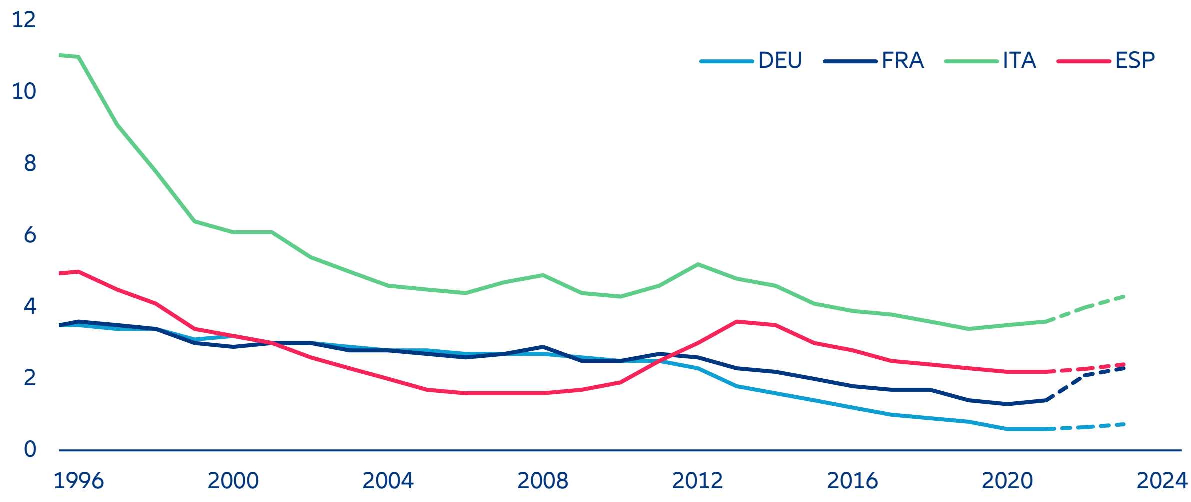


Sources: ECB, Allianz Research. Note: NFC=non-financial corporates.

As the ECB keeps raising interest rates, the pressure is visible in Eurozone governments' fiscal trends. Government debt burdens already increased massively in 2022 after years of favorable financing costs and will increase further in 2023-24 (Figure 7). Despite a reduction in rollover risks, thanks to increasingly longer maturities secured by debt-management agencies (weighted average maturity around eight years in the big four economies), debt sustainability will remain in the spotlight. We estimate that the combined impact of increasing policy rates and the ECB's Quantitative Tightening will adversely impact medium-term debt dynamics, leading to an increase in debt-servicing costs of 0.7% of GDP in Germany, 1.1% in France, 1.2% in Spain and 1.6% in Italy until 2030.

Government budgets and fiscal consolidation paths will be closely scrutinized. We expect fiscal adjustment to happen only gradually in all large Eurozone economies after three years of scaled-up public sector support. Moreover, higher borrowing costs could also translate into an increase of fragmentation risks, with more vulnerable Eurozone economies, such as Italy, seeing their sovereign spread widening. This is particularly relevant in a moment when fears of the sovereign-bank nexus are being reaffirmed forcefully, given current turmoil in the banking system, and that some lenders remain very exposed to their sovereigns, with large holdings of domestic debt securities.

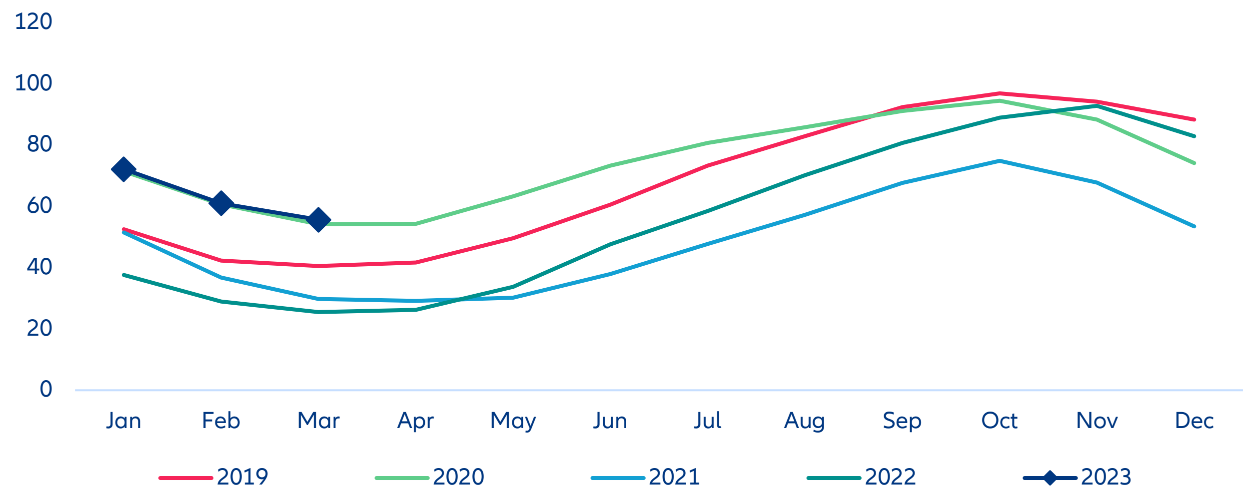
Figure 7: Government debt burden (% GDP)



Sources: Refinitiv Datastream, Allianz Research

With the ban on imports of oil products coming into force, the EU has been cut off from Russian oil as of February 2023. The EU now only imports some Russian gas through the Uzhgorod pipeline (via Ukraine) and Turkstream (about 15-20% of "normal" imports of gas) (Figure 8). Russian LNG accounted for 20% of the EU's LNG imports in February. In 2022, the EU managed to reduce gas consumption by about 20% and we believe that such a decrease can be sustained in 2023, especially since slowing economic momentum will also lead to a decrease in consumption on the corporate side. The largest unknown remains the weather from Q3 2023 onwards. Indeed, colder months in Europe showed that households have not hugely modified consumption patterns. Overall, we expect the energy gap to remain broadly stable in Europe in 2023. Natural-gas prices and wholesale electricity prices have come down quite sharply from the peaks seen late 2022. However, we feel that markets are being quite complacent as the winter season reaches its conclusion and gas storage across the continent is at rather high levels. We expect to average close to 75 EUR/MWh as markets might reprice when all European countries have to replenish their storage and rush for supply. ets and fiscal consolidation paths will be closely scrutinized. We expect fiscal adjustment to happen only gradually in all large Eurozone economies after three years of scaled-up public sector support. Moreover, higher borrowing costs could also translate into an increase of fragmentation risks, with more vulnerable Eurozone economies, such as Italy, seeing their sovereign spread widening. This is particularly relevant in a moment when fears of the sovereign-bank nexus are being reaffirmed forcefully, given current turmoil in the banking system, and that some lenders remain very exposed to their sovereigns, with large holdings of domestic debt securities.

Figure 8: EU gas storage levels, 2019-2023 (%)



Sources: Refinitiv Datastream, Allianz Research

Box 2: The central bank dilemma—price stability vs. financial stability

For both the US Federal Reserve and, to a lesser extent, the ECB, financial-stability concerns might complicate the already difficult trade-off between inflation vs. growth in setting policy rates over the next few months. Should they keep hiking rates even though core inflation is becoming increasingly sticky or prioritize financial stability over price stability? In any event, the fight against inflation is likely to be prolonged unless slowing demand is sufficiently disinflationary to allow central banks to tread more carefully.

The Fed is in a seemingly difficult position, caught between its two core objectives of financial stability and price stability. Price pressures remain stubbornly high, with the recent February CPI report showing that the pace of monthly increases in core prices is not slowing (+0.5% m/m, in line with the average since mid-2021). On the other hand, lower bond yields and the potential injection of liquidity by the Fed (through its new bank term funding program and the existing reverse repo facility) could ease financial conditions. Easier financial conditions can complicate the Fed's objective to bring inflation back to target, undermine its credibility and potentially lead to more volatile and higher inflation expectations.

Financing conditions have not moved much overall while the Fed's stance has eased because of lower short-term bond-yield expectations. Since the SVB debacle, US financial conditions, as measured by various financial condition indices (FCIs), have not moved much: lower equity prices and tighter credit spreads have been broadly offset by declining bond yields. The Fed' stance has, however, eased quite noticeably as markets have pared back Fed funds rate-hike expectations.

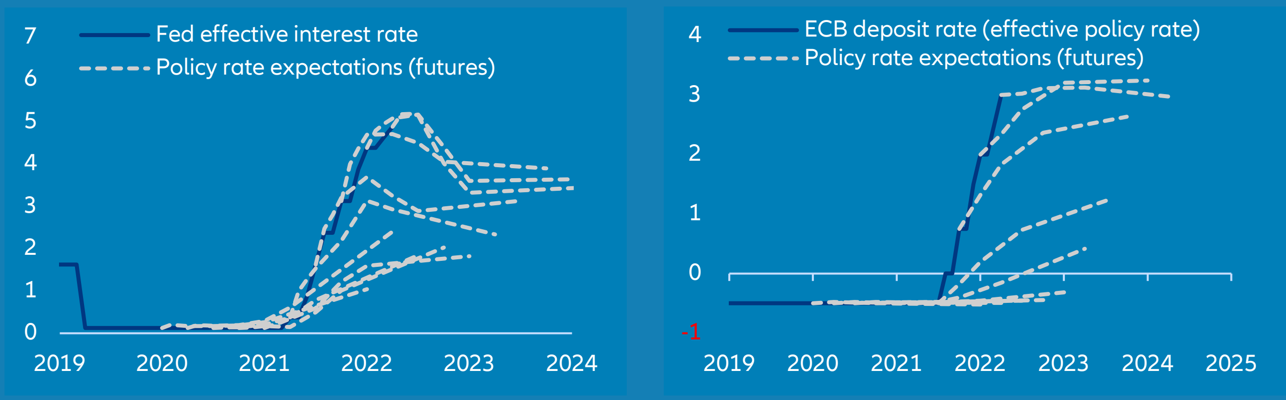
However, the SVB failure will most likely curtail the supply of credit further, squeeze demand and help the Fed to bring down inflation. The latest Senior Loan Officer Opinion Survey (Q4 2022) showed a marked tightening of credit standards across all types of products. On the housing market, the pullback in the flows of new mortgage lending suggests that real property-prices growth is bound to decline further, with probable adverse wealth effects on household consumption. It is likely that US banks will tighten lending standards further to preserve capital and build liquidity buffers.

Financial-stability considerations are less binding for the ECB's policy rate decision. The ECB will remain conscious of potential market stresses but is less constrained than the Fed for its next policy rate moves. European banks have lower valuations than their peers, but are even more liquid, have fewer asset-liability mismatches, and hold more than EUR3trn in liquidity at the central bank ("excess liquidity"), with a still-high share of unencumbered assets that could be used for accessing central bank money if funding stresses arise. As a result, there are unlikely to be forced bond sellers in Europe. However, there could be some small/individual liquidity-constrained banks, and hold-to-maturity books are not marked to market (unrealized losses do not count towards capital).

However, compared to the US, the ECB would struggle to offer remedial actions if financial stability concerns arise, given concerns over risk-sharing within the monetary union and greater concern over moral hazard. For instance, it would be very difficult for the ECB to accept collateral at par value (as was done in the US) for banks to access central bank money. The risk mitigation within its collateral framework requires the collateral to be valued at market value, after which additional haircuts related to the risk of the asset are applied. However, the ECB could lower collateral haircuts and/or broaden the pool of eligible collateral, including more flexibility in accepting credit claims (which constituted 41% of the increase in collateral deployed at the ECB in 2020 and 2021). Such a measure would be more effective in combination with new, longer-rated refinancing operations (LTROs) with a duration of at least s months to provide a stickier funding source for banks. This could also include paring back some of the changes to the targeted longer-term refinancing operation (TLTRO) lending terms and reserve remuneration in November 2022 to delay early repayments and maturing TLTROs, which would slow the decline in money supply and excess liquidity. Our estimates suggest that mothballing the current (and expected) pace of the TLTRO run-off would mitigate the potential decline in credit growth by about a quarter

Markets have not been able to gauge the monetary policy path: from too late to too aggressive. Sharp changes in central bank reactions and the highly volatile environment have left markets' disoriented when it comes to predicting official interest-rate moves for horizons above three months. While it is always hard to predict what central banks will do next, the velocity and size of hikes makes this cycle especially challenging. Guided by history, there is only one moment in which market pricing errs more than in hiking cycles: prior to emergency cuts.

Box 2, Figure 1: Market-based policy rate expectations - Fed (left), ECB (right)



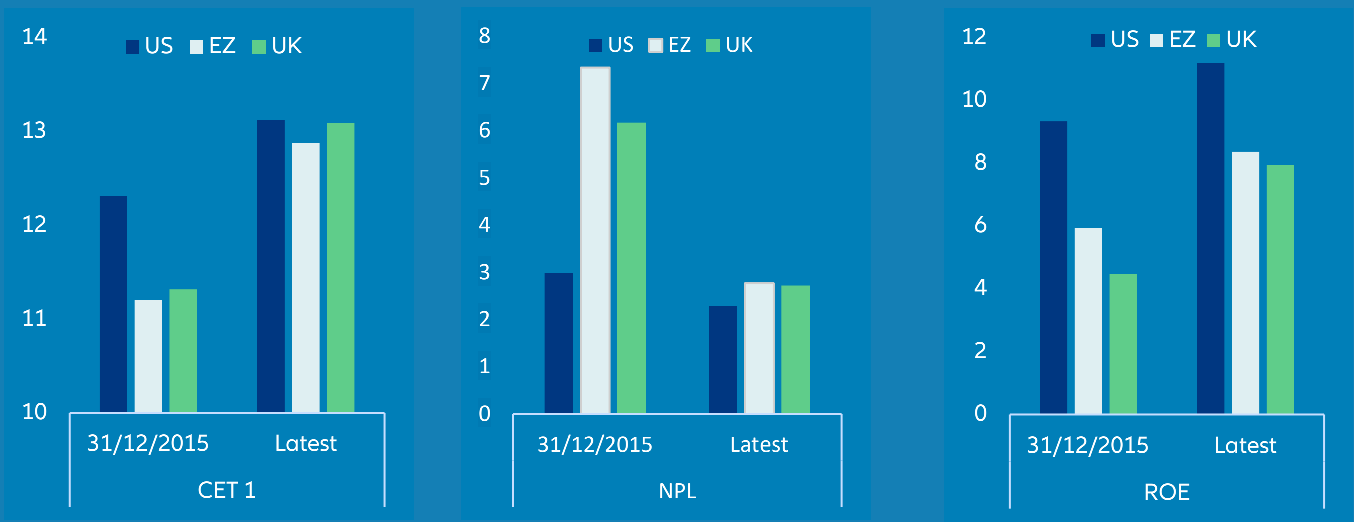
Sources: Refinitiv Datastream, Allianz Research

Photo by Dimitri Karastelev on Unsplash

Box 3: Current situation in the European banking sector

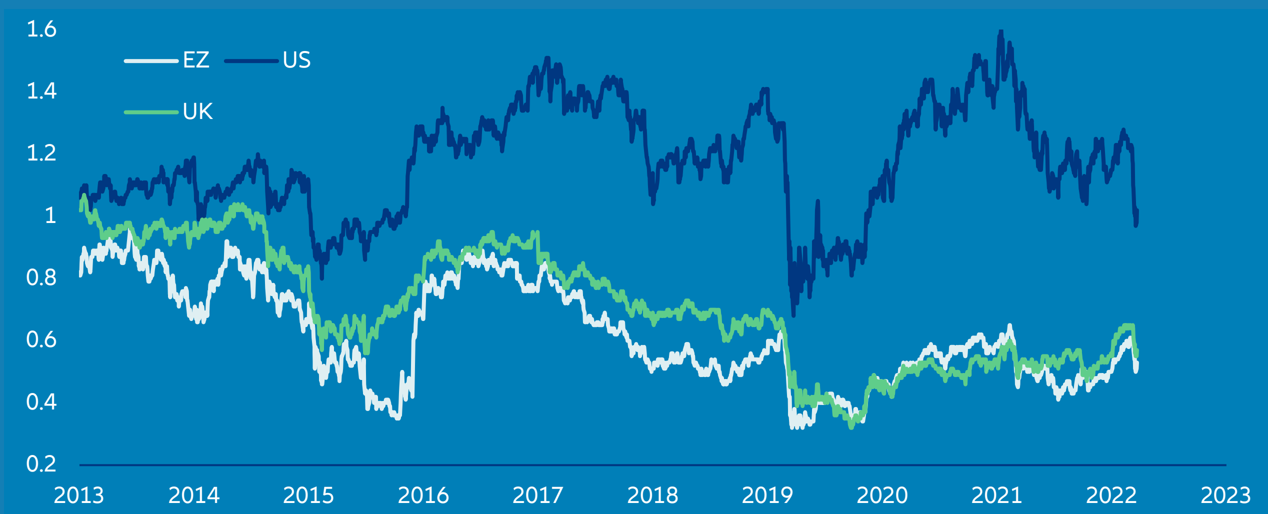
The health of the European banking sector has significantly improved over the last decade, mitigating potential spillover effects of SVB's failure. With a focus on the largest Eurozone banks (with total assets amounting to 80% of the region's GDP, we find that the sector is a much better shape today than it was in 2015 thanks to better and more consistent regulation and supervision (Box 3, Figure 1). Non-performing loans (NPLs) declined to less than 3% of the loan book (down from more than 7%) while the average common equity Tier 1 (CET1) ratio has increased by more than 2pp (and now comes close to the capitalization of US peers). Liquidity also improved, with the liquidity coverage ratio (LCR) rising from 125% in 2015 to 150% in 2022, way above the regulatory minimum of 100%. However, major US banks are on average still more profitable, with a higher return on equity (RoE) supporting also a higher price-to-book (PtB) ratio (Box 3, Figure 2). Extending our sample coverage include also smaller ones, European banks appear generally stronger (Box 3, Figure 3).

Box 3, Figure 1: Selected banking sector financial soundness indicators: capital adequacy, non-performing loans and profitability



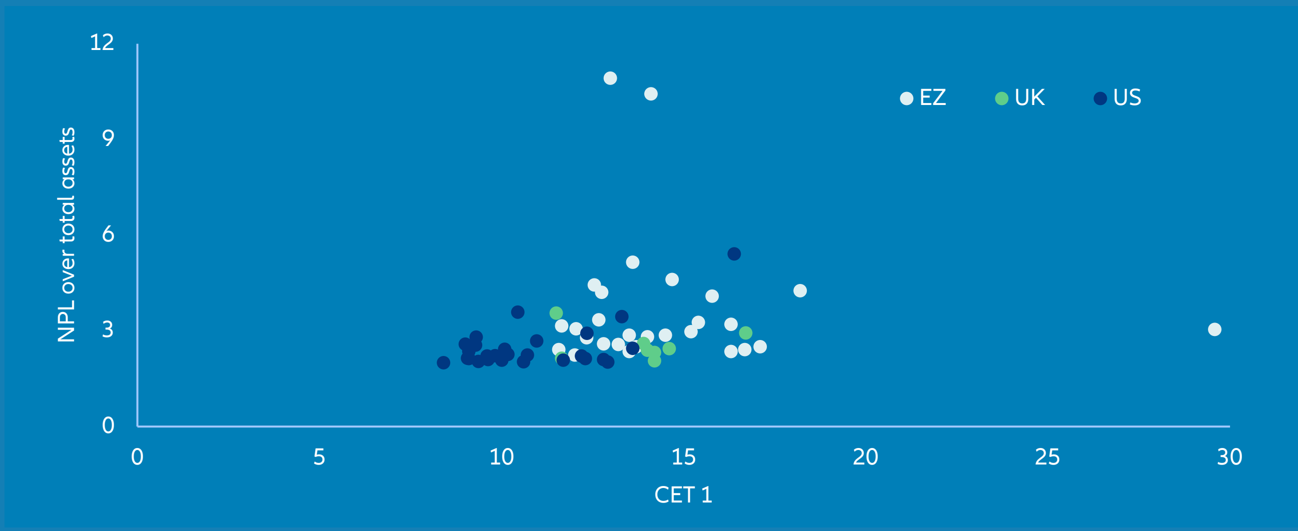
Sources: Refinitiv Datastream, Allianz Research. Note: sample covers all banks identified as G-SIBs (global, systemically important banks) in each country/region; CET1=common equity Tier 1 capital ratio; NPL=non-performing loan ratio; ROE=return on equity.

Box 3, Figure 2: Banking sector: price-to-book ratio (21 March 2023)



Sources: Refinitiv, Allianz Research

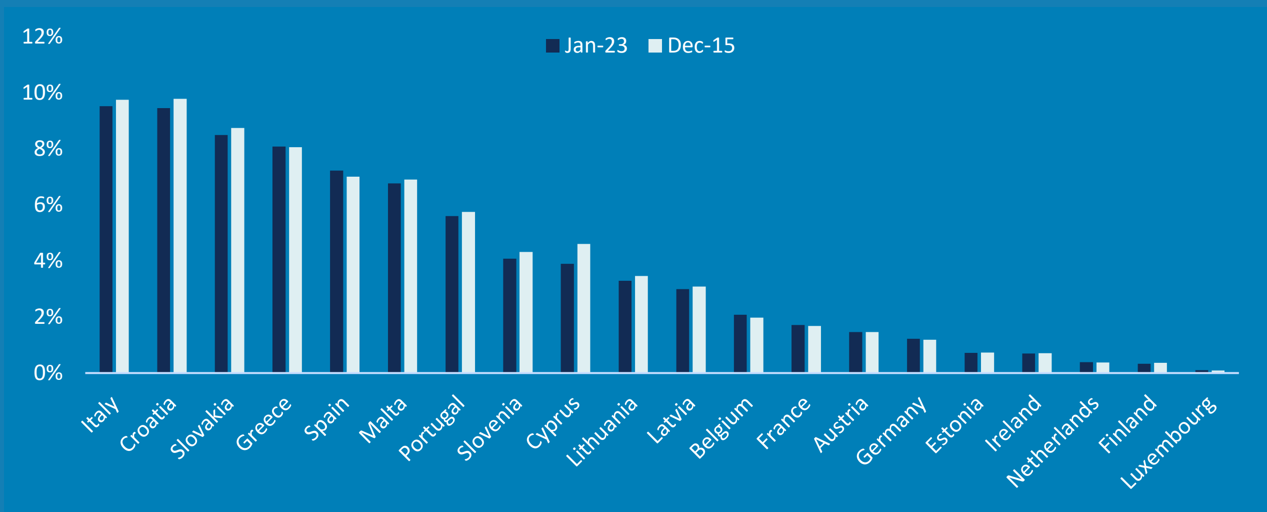
Box 3, Figure 3: Eurozone banking sector: asset quality vs. capitalization



Sources: Refinitiv, Allianz Research. Note: Banks from Germany, France, Italy, Spain, Greece and Ireland are included in the Eurozone sample.

European banks learnt their lessons from the Euro sovereign debt crisis. However, some countries remain very exposed to their sovereign (Box 3, Figure 4), with banks sitting on large holdings of domestic debt securities – also due to the banks' need for liquid assets. The risks of feedback loops can materialize in two directions: when the banking sector's troubles translate into fiscal costs and when the price of sovereign debt impairs banks' government debt holdings on their balance sheets. This is particularly pronounced when holdings are recorded at market value. The bank-sovereign nexus poses serious risks to financial stability and has been only partially addressed in recent years (no material reduction in domestic debt holdings).

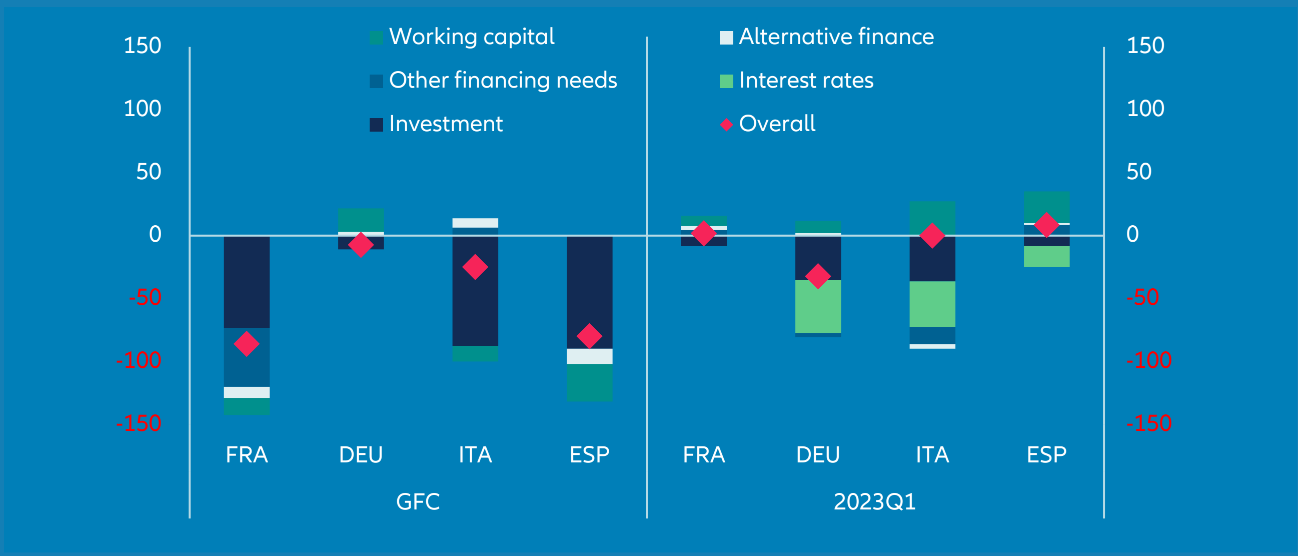
Box 3, Figure 4: Eurozone banking sector: asset quality vs. capitalization



Sources: ECB, Allianz Research

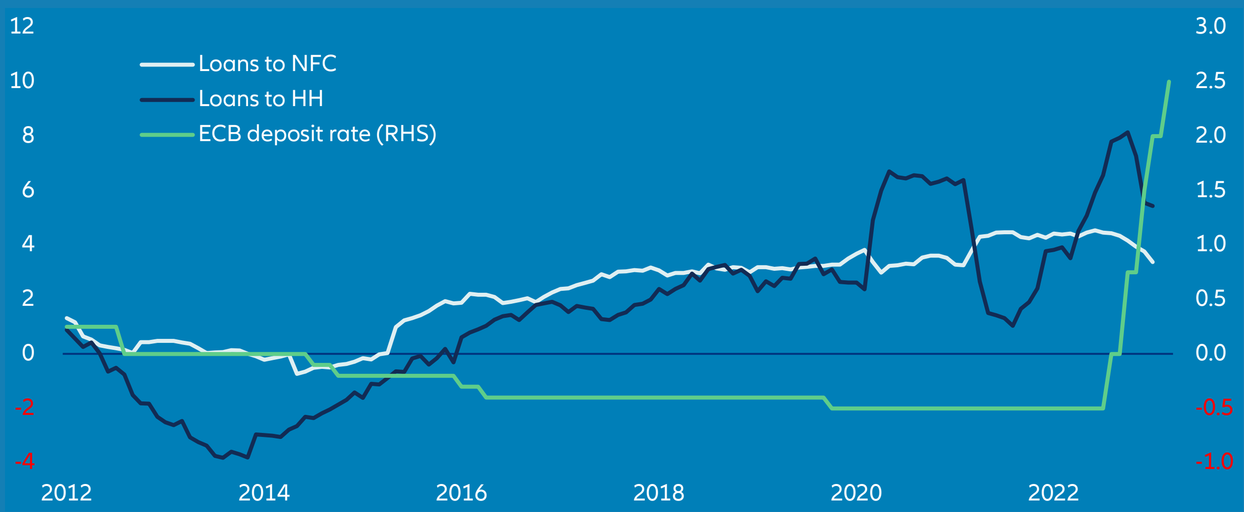
The current turmoil in the banking system adds further pressure to the sector. Deteriorating money and credit dynamics are already suggesting that the ECB's policy hikes are having real bite - with more pain potentially ahead. Annual growth of money supply and loans to the private sector decelerated significantly in January 2022, with aggregate M2 annual growth down sharply to 3.5% , and loans to non-financial corporations decreasing significantly. Protracted uncertainty denting investment decisions and higher interest rates clearly impacted firms' and households' borrowing. The latest ECB Banking Lending Survey (published in late January) confirmed a record decline in net demand for housing loans in Q4 last year due to higher interest rates, lower consumer confidence and deteriorating housing market prospects. In parallel, credit conditions have tightened significantly. Credit standards for loans to enterprises also tightened, and firms' demand for loans decreased for the first time since the beginning of 2021, with rising interest rates mentioned as a key driver (Box 3, Figures 4 and 5).

Box 3, Figure 5: Eurozone – Bank Lending Survey: Factors contributing to change in NFC credit demand

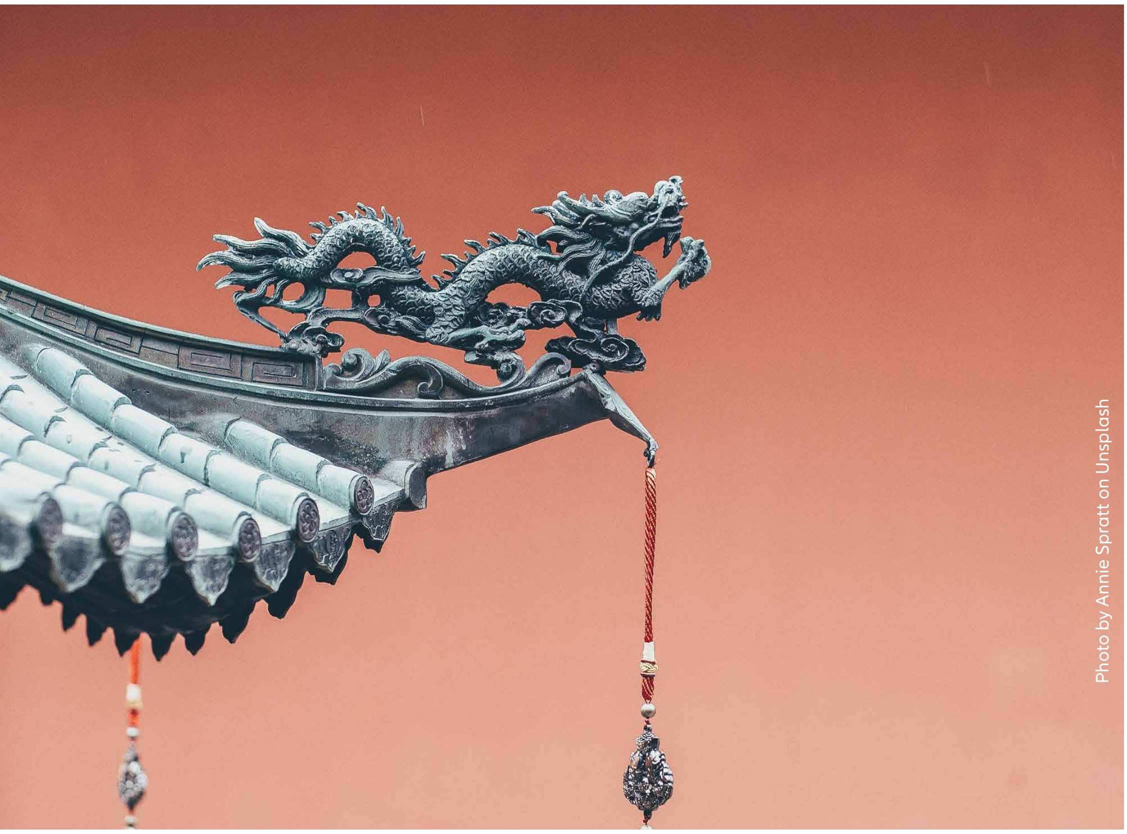


Sources: ECB, Allianz Research

Box 3, Figure 6: Eurozone – Annual loan growth vs. ECB policy rate (%)



Sources: ECB, Allianz Research



China: the reopening is paying off, but risks remain

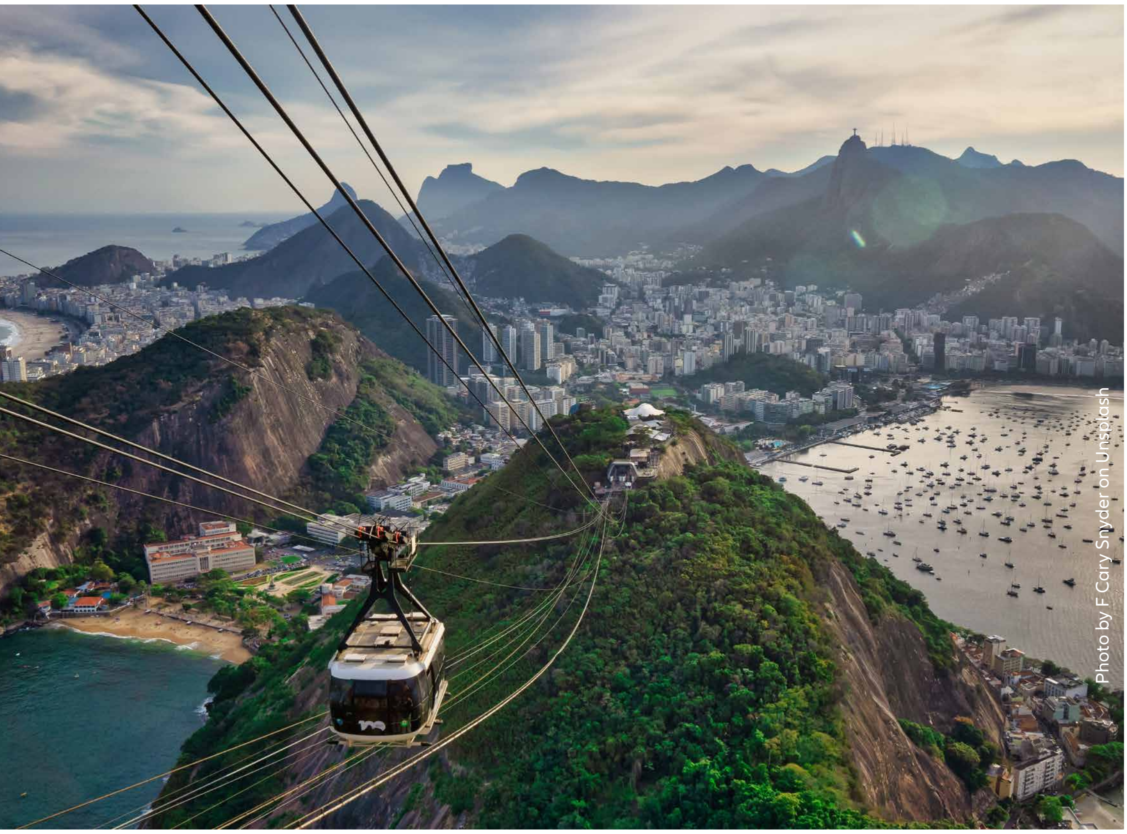
The outlook for the Chinese economy has improved. The relaxation of Covid-19 measures and reopening has moved sooner and faster than expected. National urban mobility rebounded to +11.8% y/y in February 2023 (after -9% in Q4 2022 and -8% in January), even exceeding the pre-pandemic average when accounting for seasonality. We do not think this initial phase of exuberant optimism is likely to last very long, but high-frequency indicators are pointing towards a normalization of consumer behavior (mobility at +3.2% y/y in the first half of March) – at least domestically. This means that this year is likely to bring about a consumer-led recovery for the Chinese economy: We expect real GDP to grow by +5.0% in 2023 (after +3.0% in 2022), followed by +4.8% in 2024.

Continued vulnerabilities explain our relatively cautious forecast for 2023, though risks of revisions are likely skewed to the upside. Our +5.0% growth forecast for 2023 compares with a consensus at +5.3% and a conservative official target of "around 5%" (the government tends to set itself comfortably achievable GDP targets). We expect the main driver of the recovery, private consumption, to grow by +8.2% in 2023 (compared with +12.3% in 2021, another post-Covid year). Indeed, while some revenge spending can take place in the early stages of the reopening, we think the strength of the consumer rebound could be mitigated by three factors: (1) the labor market has not normalized yet (the unemployment rate edged up to 5.6% in February, compared with a pre-pandemic average of 5.1%); (2) excess savings are not as abundant as in other post-Covid experiences (we estimate RMB3.4trn, i.e. 2.7%

of the 2023 estimate nominal GDP); (3) the real estate sector is stabilizing but will not experience a strong trend reversal. More specifically, housing prices are likely to stop declining sequentially as policy measures are supporting housing sales, but authorities are likely still aiming for some consolidation among real estate developers. As a result, further small defaults could happen.

Less policy support is on the cards as Chinese authorities also look to tackle structural issues. On the fiscal front, the target for new issuance of local government special bonds was set at RMB3.8trn this year, a lower level than expected. This suggests a likely moderate pace of infrastructure investment as the government probably aims to reduce the fiscal deficit. On the monetary policy front, an easing bias is likely to be retained this year, with support specifically provided to some industries and firms (e.g. SMEs). We no longer expect any broad-based changes in the policy interest rates (LPRs) this year. The PBOC's announcement of a 25bps cut in the RRR on 17 March (effective from 27 March) came as a small surprise and probably highlights authorities' willingness to support market sentiment in the context of a conservative growth target for 2023 and banking-sector stress abroad. Recently announced institutional reforms clearly show that Chinese authorities are also focusing on the long term, with the establishment of the Central Financial Commission and the Central Science and Technology Commission. This suggests a further Party push and oversight in the financial sector and in technological innovation.

Photo by F Cary Snyder on Unsplash



Emerging markets: the head is still on

Emerging markets (EMs) are not out of the woods yet. Economic growth in EMs will slow down in 2023 as the lagged effects of high inflation, tighter monetary policy and global financing conditions will come into force. Broad-based commodity exporters (e.g. Brazil, Cameroon, Côte d'Ivoire) and some oil producers with potential (Angola, Colombia, Saudi Arabia) will still benefit from the current cycle in 2023 even if prices moderate somewhat, but specialized commodity exporters (e.g. Chile, South Africa) may suffer due to shifting demand and production constraints. Upside risks to our China forecasts may have some positive effect, mainly in other Asian markets – notably to southeast Asia as China's outbound tourism resumes – but less elsewhere in EMs. The impact may also be more domestic in China.

Monetary policy space will remain limited in 2023-2024, with inflation subsiding moderately but remaining sticky and thus above central banks' target range in most EMs. Most central banks in Latin America and Emerging Europe will keep interest rates high/elevated for longer while a few more hikes are expected in Asia before a gradual pivot in the second half of the year, mostly towards end-2023. The picture in Africa is more mixed, with distressed economies likely in need of hiking more (e.g. Egypt, Kenya, Nigeria) while others may pivot in late 2023 (e.g. Ghana, South Africa). Although the downward adjustment in Fed interest rates would in theory provide some relief for EMs (in the form of a weaker USD and some space for cuts), the fact that it has been triggered by banking stress episodes has the opposite effect and could spark liquidity shortages and spread contagion to local banking sectors.

Most EMs, especially commodity importers, also face a lack of fiscal space owing to pandemic-related support measures that have stretched public finances, as well as significantly increased financing costs. Sovereign debt distress is likely to rise further during 2023 in developing economies but also among larger EMs. Longer-than-expected negotiations with bilateral creditors and debt-relief initiatives, as well as lengthy restructuring processes in many low- and middle-income economies, will push refinancing costs up and limit investment flows.

Table 3: Key challenges

Key challenges	
EM Asia (ex China)	Growth in EM Asia ex-China to slow to +5.6% in 2023 after +5.8% in 2022. This compares with an average of +8.0% in the 2010s.
	Economies exposed to exports and cyclical sectors (e.g. South Korea, Taiwan) are likely to see a relatively bigger step down in growth.
	Downside factors affecting most of the region, e.g. elevated interest rates and inflation (albeit lower than in other regions). Domestic demand has turned a corner in almost all markets and is set to slow (India and Indonesia slightly more resilient).
	Lower balance-of-payment (BoP) risk than in other regions of the world, with Malaysia, Indonesia and the Philippines relatively more exposed among major economies of EM Asia. Pakistan and Sri Lanka will only slowly leave behind the 2022 debt concerns.
	Elections are scheduled in Thailand in 2023 (May) and in Taiwan (January), Indonesia (February) and India (May) in 2024. Geopolitical tensions, notably under the shadow of US-China tensions, will continue (though an outright conflict is unlikely).
Emerging Europe	Stagflation fears are not off the cards yet as we forecast a marked slowdown of economic activity this year (even though the outlook has slightly improved during Q1) and inflation to remain sticky.
	Limited monetary and fiscal policy space challenges CEE policymakers to find the right policy mix and good policy communication:
	Large twin deficits call for tight monetary and fiscal policy stances in 2023.
	Tight monetary policy to continue due to tight global liquidity conditions, sticky inflation, rapid wage growth and the potential for renewed currency volatility.
	Public finances are still stretched from measures to cope with the pandemic while financing costs have increased.
	A BoP crisis continues to loom in Hungary and Romania and is in place in Turkey.
	An energy crisis in winter 2023/2024 cannot be ruled out.
	Elections in 2023 are scheduled in Turkey (May, presidential and legislative) and Poland (November, legislative), providing room for policy mistakes in the run-up to the polls.
Latin America	Economic growth in 2023 expected to be significantly weaker than last year
	Inflation might moderate after peaking H2 2022, but is expected to remain above target throughout 2023. Although headline inflation is on a downward trend, progress in core and services inflation has been much slower.
	Limited scope for rate cuts in H2 2023 due to the persistence of above-target inflation, unanchored inflation expectations, policy uncertainties and political risk premia (eg. Peru, Chile, Colombia).
Africa	Pressures resulting from macro-financial conditions continue to unfold amid subdued growth, elevated import costs and tight liquidity. Several economies are grappling with a cost-of-living crisis due to restricted food supply options and distorted energy markets, combined with thin fiscal and monetary space.
	Average monetary policy rate is forecasted to be around 11.5% across the region in mid-2023, compared to an average of 8.6% one year before. Restoring business confidence and growth among the top three African economies continues to be an uphill struggle.
	Institutional strength, liquidity and debt sustainability remain thorny issues for Nigeria, Egypt and South Africa, which represent almost half of Africa's GDP. Election results in Nigeria have not yielded a clear mandate due to the lowest turnout in history. The central bank is also grappling with credibility issues and cash shortages amid prolonged inflation (22% in February) resulting from structural imbalances in trade.
	Food prices in Egypt have risen by 62% in the year following Russia's invasion of Ukraine, despite moderation in global food prices. A liquidity crisis has brought a severe depreciation of the pound and sticky inflation (32% y/y in Feb; we forecast an average of 24% in 2023). Sovereign yields reached 23% on 1Y maturities in March despite the IMF program. While reforms under the program may weigh on short-term prospects, lenders from across the Gulf could try to gain more leverage over the country's strategic assets (incl. the Suez Canal).
	Economic stagnation remains on the horizon for South Africa this year (+0.7%), as output in the energy-intensive mining and manufacturing sectors is still below pre-pandemic levels due to load shedding, political instability, increased insecurity and fiscal consolidation efforts.

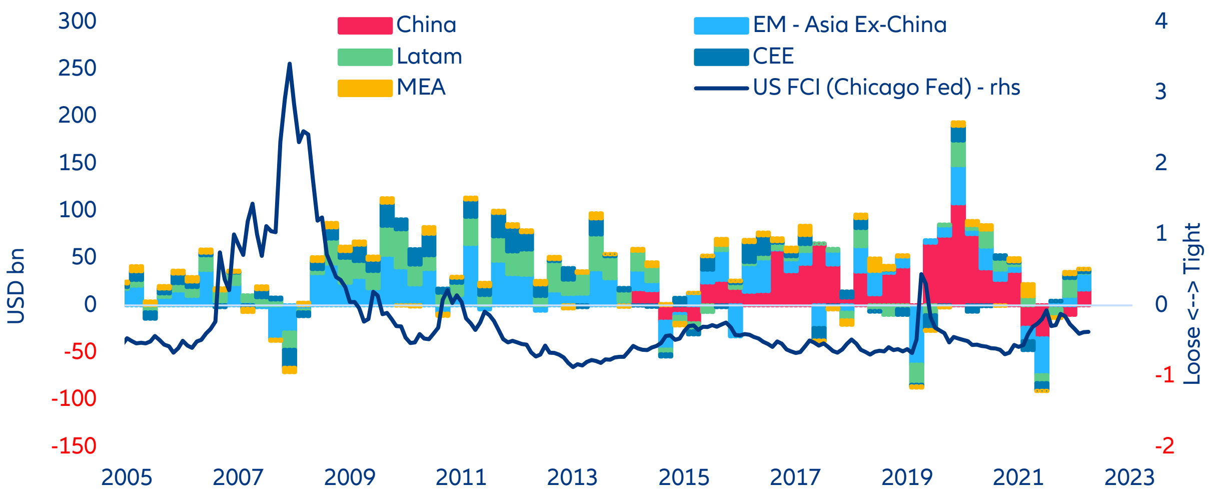
Source: Allianz Research

While markets have tried to search for the positive side of every development, EMs will face a tough reality this year. China's earlier-than-expected reopening together with better-than-expected economic data in Europe and the US increased risk appetite for investors. As a result, EMs saw an uptick in portfolio inflows in the beginning of the year. However, challenges persist (Figure 9). We expect the global financial environment to be highly volatile over 2023 as investors assess the path of US interest rates, depending on inflation as well as the US bank turmoil and potential spillovers. Indeed, the recent events in the financial system have sparked a correction in risky assets and above all have led investors to readjust their expectations from the Fed to a lower level for interest rates. The effects on EMs have been two-fold as spreads widened but the overall impact on yields was cushioned by the adjustments in US rates. Even as the Fed policy path eases, the global financial system has been hit with an abrupt tightening, the consequences of which are only starting to emerge, that could tighten much more should the panic spread over the system, draining interbank lending, and, in the case of EMs, sparking a flight to safety. A reversal of the portfolio inflows trend since November 2022 is about to happen (high-frequency data points to deterioration ex-China) as investors reassess the repercussions that current financial distress could spark in weaker emerging economies. The reopening of central bank swap lines in advanced economies is as much reassuring as it is telling of how dangerous the situation has become.

Monetary policy space will remain limited in 2023-2024, with inflation subsiding moderately but remaining sticky and thus above central banks' target range in most EMs. Most central banks in Latin America and Emerging Europe will keep interest rates high/elevated for longer while a few more hikes are expected in Asia before a gradual pivot in the second half of the year, mostly towards end-2023. The picture in Africa is more mixed, with distressed economies likely in need of hiking more (e.g. Egypt, Kenya, Nigeria) while others may pivot in late 2023 (e.g. Ghana, South Africa). Although the downward adjustment in Fed interest rates would in theory provide some relief for EMs (in the form of a weaker USD and some space for cuts), the fact that it has been triggered by banking stress episodes has the opposite effect and could spark liquidity shortages and spread contagion to local banking sectors.

Most EMs, especially commodity importers, also face a lack of fiscal space owing to pandemic-related support measures that have stretched public finances, as well as significantly increased financing costs. Sovereign debt distress is likely to rise further during 2023 in developing economies but also among larger EMs. Longer-than-expected negotiations with bilateral creditors and debt-relief initiatives, as well as lengthy restructuring processes in many low- and middle-income economies, will push refinancing costs up and limit investment flows.

Figure 9: Emerging markets – foreign portfolio

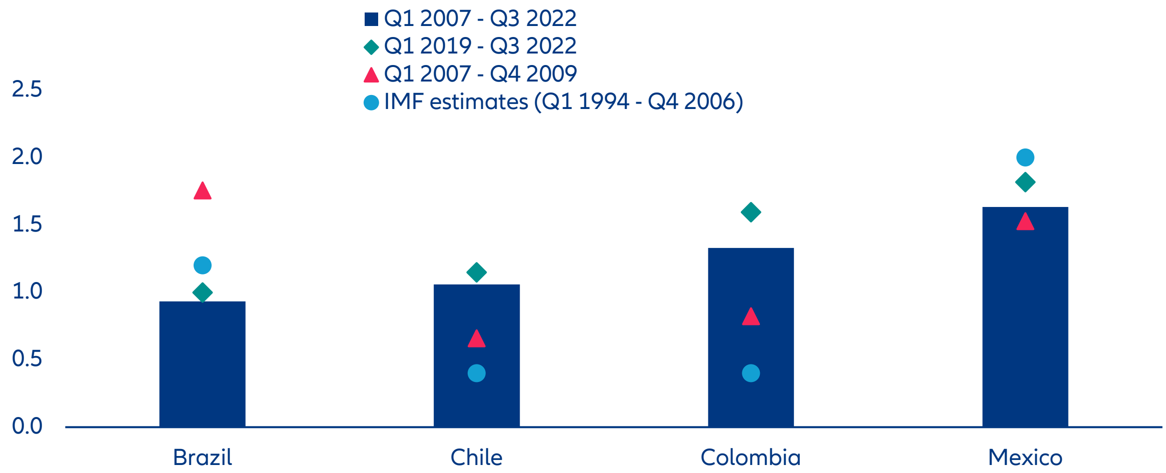


Sources: IIF, Refinitiv Datastream, Allianz Research. Note: monthly data aggregated by quarter, latest month February 2023. Different countries report data with different lag, but latest data is still representative due to the size of reporters.

We expect market sentiment to improve in the short term, favoring emerging markets, especially those with currencies with high carry trades. However, the market rally is likely to be temporary. In the second half of the year, we expect investors to shift their focus from inflation to growth, given (i) the approaching recession in the US, (ii) a possible disappointment in Chinese economic growth (our growth forecasts are below consensus) and (iii) uncertainties over natural gas storage in Europe – the energy crisis is off the radar but not yet over. Uncertainty about global growth is likely to weigh on risky assets. Among emerging markets, Latin American economies could be particularly vulnerable, given their close economic and financial links with the US.

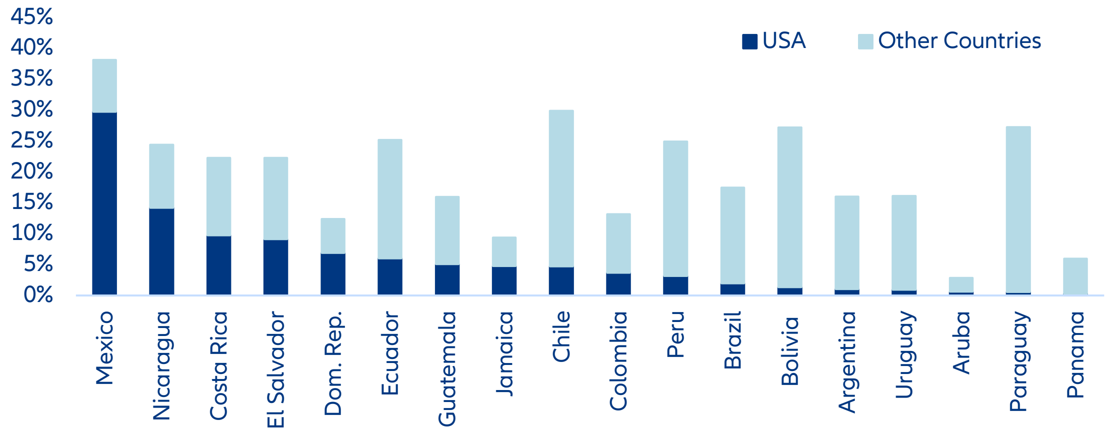
On average, the impact of a US growth shock is roughly one-to-one in the region. Of course, different economic characteristics mean that the impact varies considerably (Figure 10). A rough estimate to capture the exposure of the region's major economies to the US growth shows that Mexico would be the most affected, which can be explained by its geographical proximity and its export dependence; Mexico is among the key trading partners of the US (Figure 11). South American economies have limited trade links with the US, but would be indirectly affected by the impact on global growth and commodity prices. Much of Central America's exports are destined for the US, although these countries tend to have a more diversified export market base. Remittances from migrant workers in the US also play a key role.

Figure 10: Latam-4: Growth elasticities to the US cycle



Sources: IMF, Refinitiv, Allianz Research. Note: IMF estimates based on Österholm and Zettelmeyer (2008).

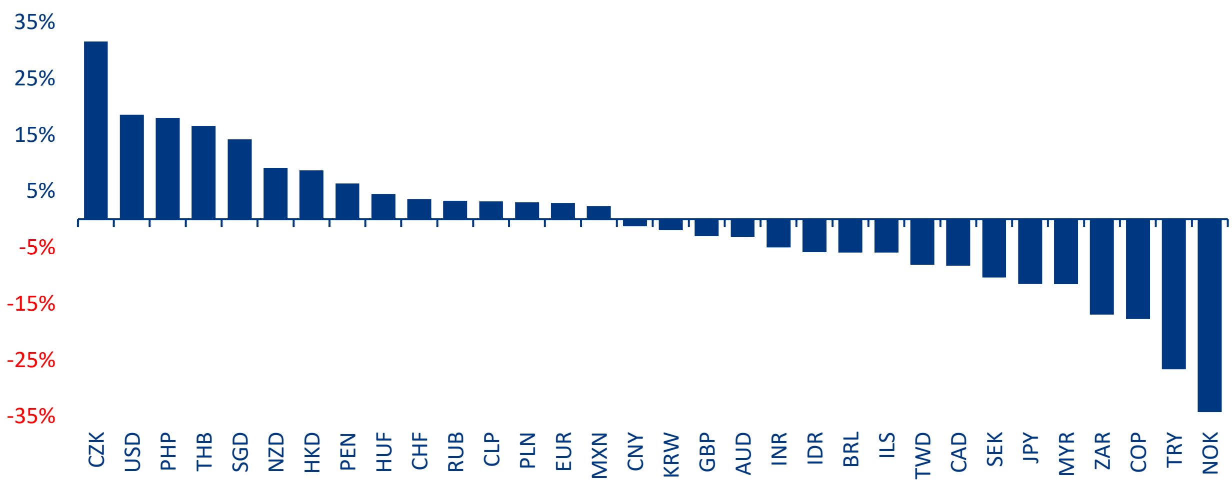
Figure 11: Latin America: exports by destination (% GDP, 2021)



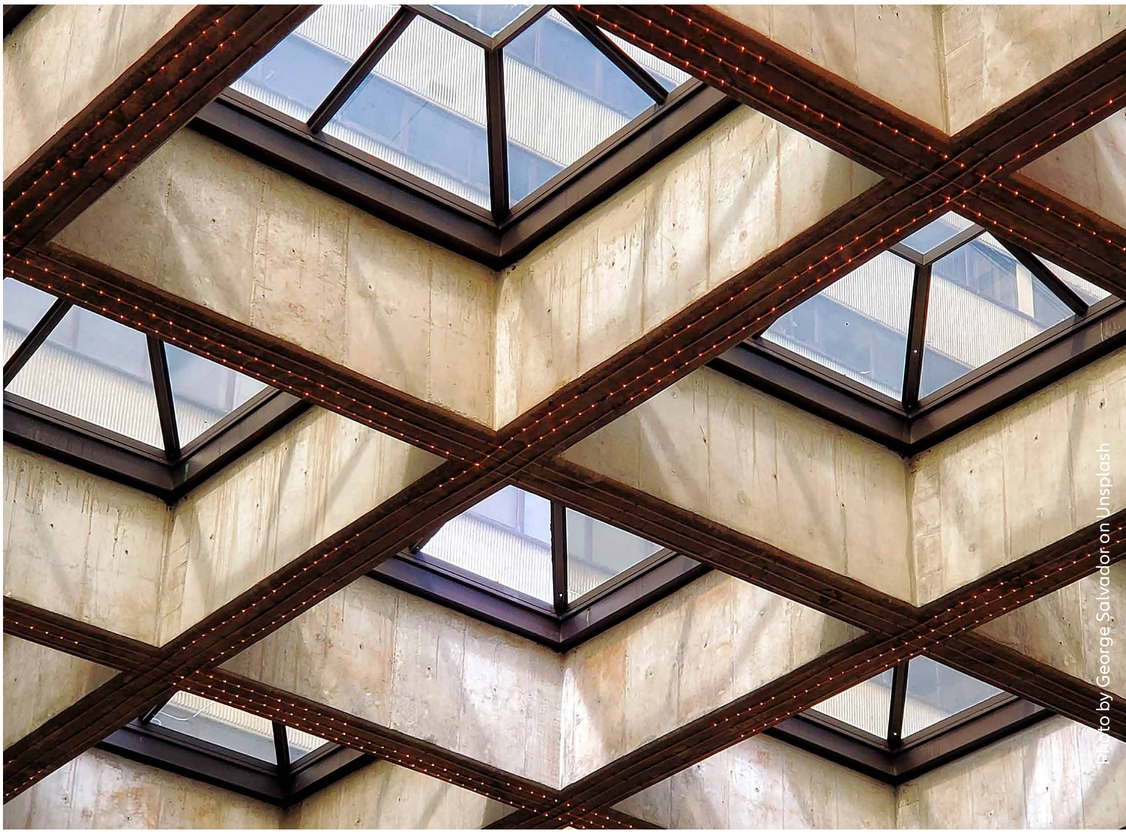
Sources: Refinitiv Datastream, Allianz Research

The reversal of early-year optimism is coming for foreign portfolio flows, too; downside risks dominate. The risk-on sentiment at the start of the year boosted EM currencies, especially those in the Latam bloc, led by tailwinds from the earlier and faster-than-expected Chinese reopening and the commodity boom. Stronger-than-expected US economic data and recent concerns about financial stability have given the USD a boost, but the Chilean peso (CLP) and Colombian peso (COP) are still the best performers of the year, largely due to a late catch-up with their peers. In the short term, a still hawkish but more cautious Fed coupled with limited global financial stability risks should boost EM currencies, especially those linked to services, those benefiting from the Chinese reopening and those with high carry. The removal of specific risks should also help, for example in the case of the Brazilian Real (BRL), which should benefit from the new fiscal rule to be announced by the new government. The presence of still high political risks, as in the case of Chile with the drafting of the new constitution in May/June, should limit gains, as should ongoing political uncertainty in Peru. The Colombian peso has room to appreciate further (our models indicate that the currency is extremely cheap), but the government needs to restore confidence in the markets. In the second half of the year, the outlook is generally gloomier for emerging currencies, which should be affected by the more complicated external scenario that should increase risk aversion (USD positive). Countries with sounder macroeconomic fundamentals and less external exposure should benefit - e.g. Brazil due to high interest rates.

Figure 12: FX valuation



Source: Allianz Research, March 2023. Purchasing Power Parity (PPP), Behavioral Equilibrium Exchange Rate (BEER), Fundamental Equilibrium Exchange Rate (FEER) models (trade-weighted based). For every currency, models with larger errors are penalized.



Capital markets: it´s the banks... again!

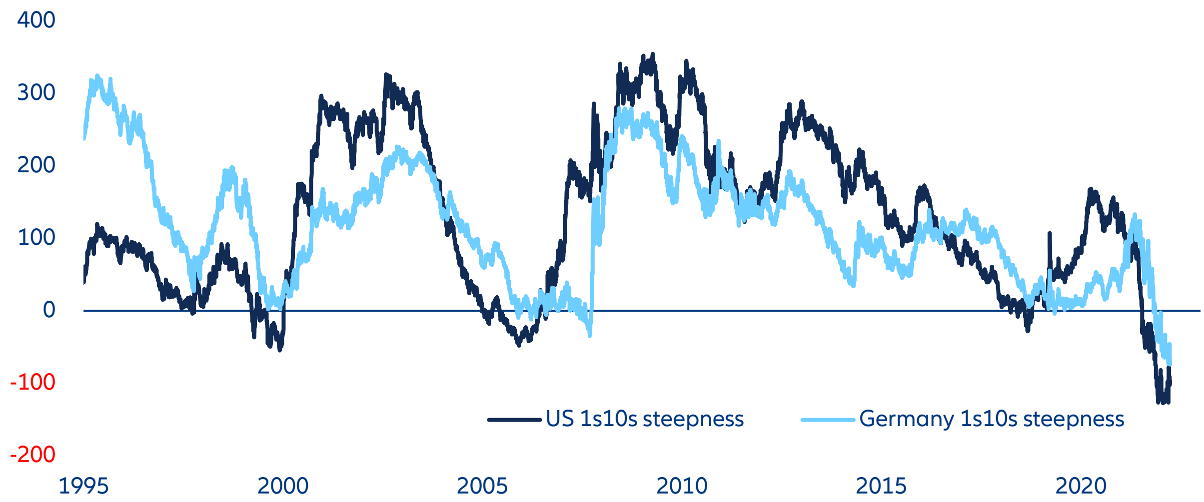
Mired in uncertainty, markets will continue to navigate like a rudderless ship. After a remarkable performance at the turn of the year, the path to market stabilization hit a stumbling block in February and March in particular. Volatile expectations around the monetary policy path continue to put profitability, growth and market liquidity in jeopardy. In this context, the combination of stickier-than-expected inflation, more-resilient-than-expected growth and surfacing liquidity problems in the banking sector have created the perfect environment for volatility to thrive, and for conflicting economic, market and financial stability views to recursively take over pricing and momentum, making it difficult for market participants to form strong convictions. Against this backdrop, a cautious approach is the best option in 2023. We continue to favor high-quality fixed-income instruments, which still offer a decent risk-adjusted profile and should manage well in a high-volatility environment. Our capital market playbook for the antechamber of a financial crisis is based on four commandments.

First, dare to be cautious

The recent liquidity issues in the US and Swiss banking sectors and central banks hikes have added to an already stressed market environment. This has reaffirmed the consensus that the line between resilience and recession is very thin and could be easily crossed, with some market participants eager to reduce risk exposure.

Sovereign curves have quickly moved from inflation to recession. Initially, the inflation-driven hawkish repricing at the turn of the year led market participants to anticipate both higher central bank peak rates in the short-end and somewhat higher long-term inflation and real rates in the long-end. The new paradigm has led market participants to expect far lower peak rates in the short-end of the curve and a strong downward revision of both inflation and real yields in the long-end, with recessionary pressures being more strongly priced in. This curve reshaping has reemphasized the differences in economic dynamics between the US and the Eurozone by acknowledging an increased likelihood of an early US recession and a prolonged hiking path in the Eurozone (Figure 13).

Figure 13: Sovereign curve steepness

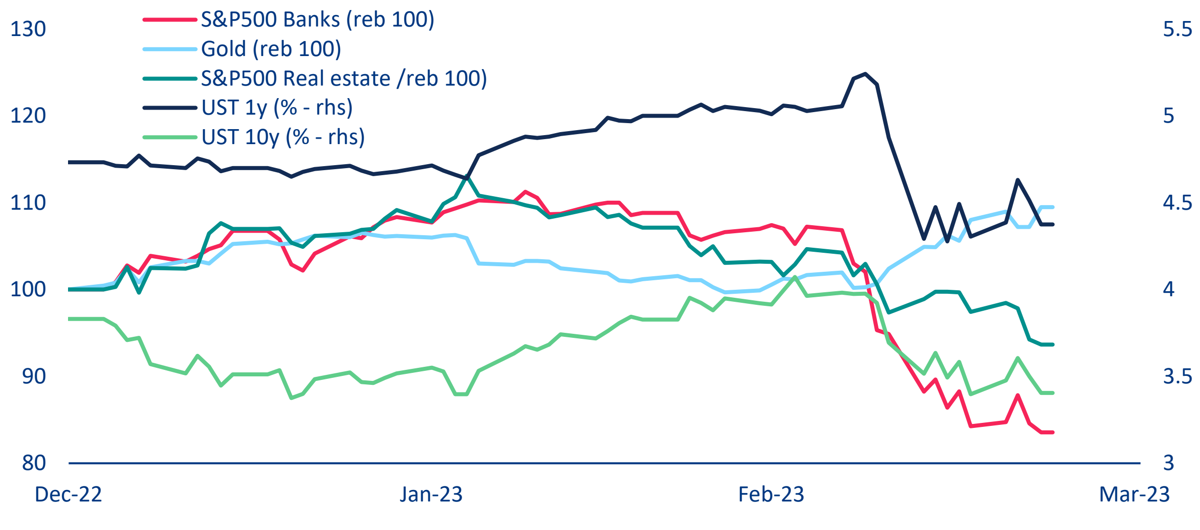


Sources: Refinitiv Datastream, Allianz Research

The banking liquidity issues, while relatively isolated, are still relevant to the system and have triggered a flight-to-safety rotation. As a result, the year-to-date market performance has been fully reversed, raising doubts about the smoothness and speed of the 2023 market stabilization (Figure 14).

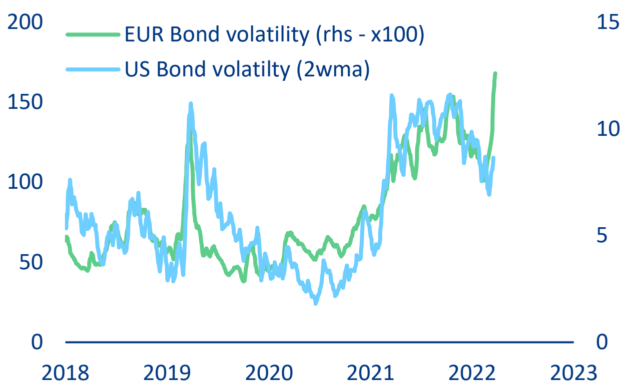
The truth probably lies between the "hawkish" scenario priced in two weeks ago and the "dovish" scenario priced in today, provided that the risk of a Great Financial Crisis/ Euro-crisis-like scenario is still remote. In this context, investors should continue with caution and prepare for elevated volatility in both the fixed income and equity side in the short run. A precautionary stance favoring high-quality fixed-income instruments could prove valuable in the short run and for as long as inflation dynamics and financial stability are not kept under control (Figure 15).

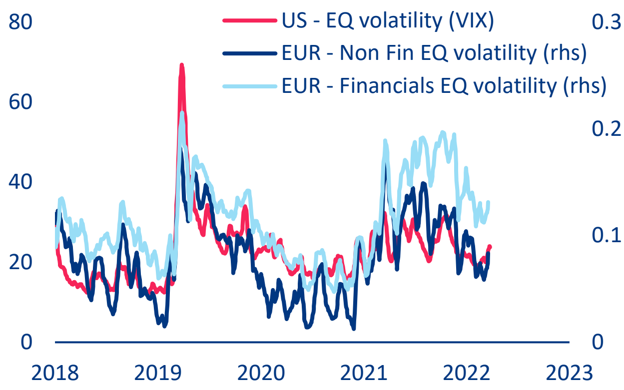
Figure 14: US markets – flight to safety



Sources: Refinitiv Datastream, Allianz Research

Figure 15: Bond and equity volatility



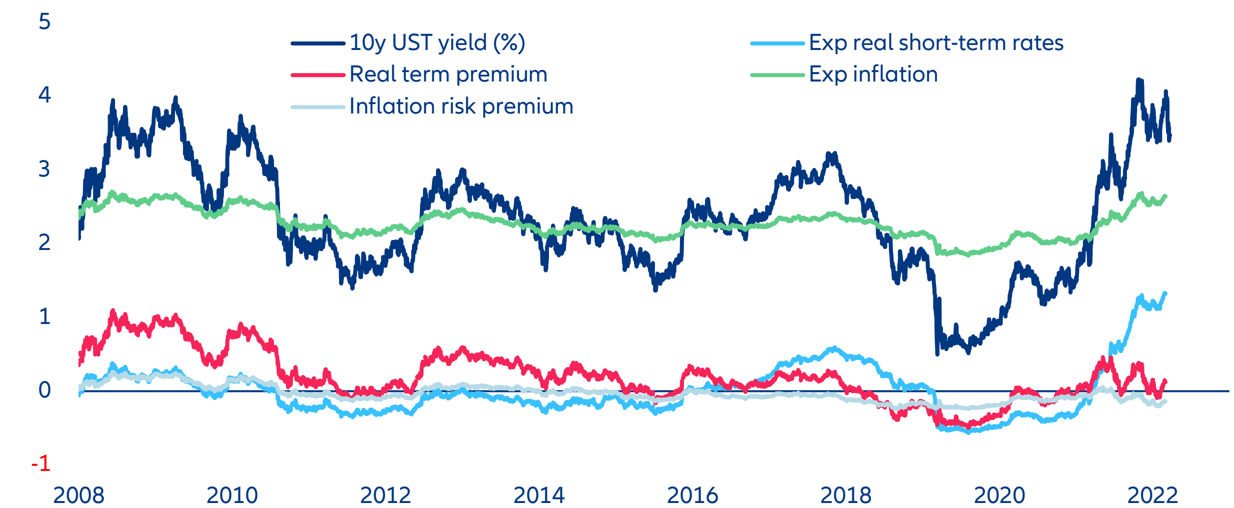


Sources: CISS, Refinitiv Datastream, Allianz Research. Note: measured as biweekly weighted-moving average

Second, watch out for duration positioning

Changes in the short-end of sovereign curves, due to changes in inflation-growth dynamics and financial-stability concerns, continue to exert substantial pressures on the long end of the curve, leading the 10y maturity bucket to experience a 70% to 90% pass-through effect from changes in policy-rate expectations. In numbers, for each 100bps change in the short end of the curve, 70-90bps are being structurally transmitted to the long end, with bigger dependencies (>1) if the intra-week move is big. Within this environment, and acknowledging that true long-term economic dynamics are currently having little impact on the determination of the long end of sovereign curves, it is not a good idea to take big duration bets as the risk of an untimely entry is extremely high and will continue to be in the near term. Trying to see the forest for the trees, we continue to believe that the true short-term equilibrium value for 10y maturities may currently live between the peak hawkishness experienced at the beginning of March (ie. 4.1% for 10y UST) and the current market dovishness (ie. 3.3%) . As a result, short-term inflation surprises may still provide market participants with some upside risks for the long-end of the curves, thus leaving long-duration positions exposed to short-term volatility. However, and despite the short-term risk, we expect the long end of developed market curves to continue range trading during the first half of the year, with a +/- 50bps corridor around our baseline scenario estimates. Later in the year, we expect short-term upside risks to fade away, especially towards the end of the year, coinciding with the beginning of the US policy pivot. When it comes to our baseline estimates, we target 3.7% and 2.4% for the 10y UST and Bund, respectively, in 2023 and a 3.3% and 2.2% in 2024. (Figure 16)

Figure 16: US 10y decomposition (in %)



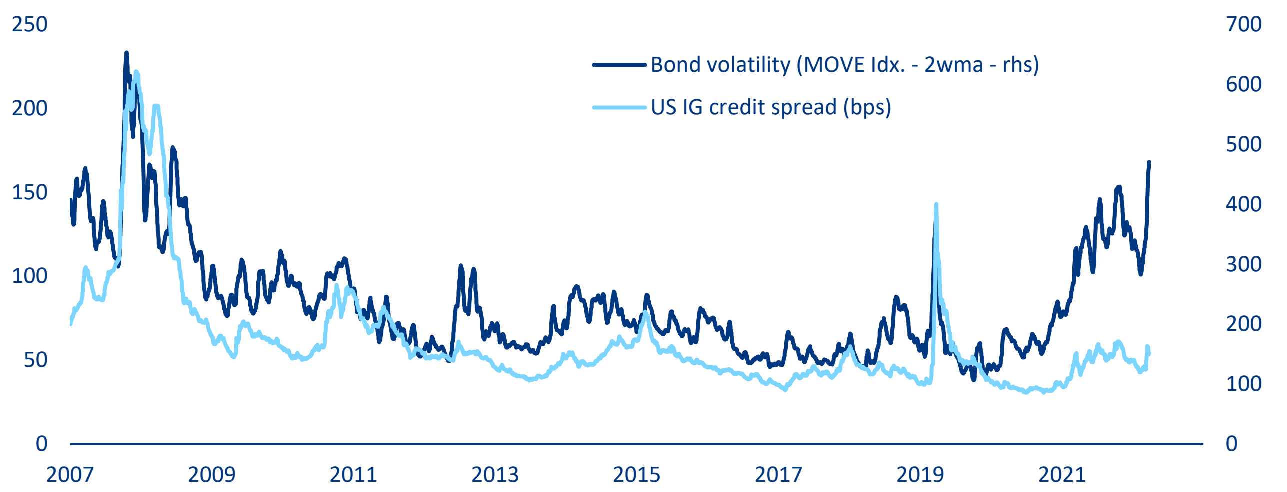
Sources: Refinitiv Datastream, Allianz Research. Note: based on D'Amico et al. (2019)

In the current elevated curve-volatility world, it is relevant to acknowledge the relatively good behavior of EUR peripheral spreads, with the Italian long end of the curve remaining relatively immune to increases in the base rate as market participants remain confident on the ECB's spread-control tools and commitment. In this regard, we expect peripheral spreads to continue to offer decent performance throughout the year, but we do not rule out periods of extenuated volatility, especially once the ECB is reaches peak hawkishness and Quantitative Tightening procedures accelerate. In numbers, we target 190bps for the Italian 10y spread for 2023 and 170bps for 2024.

Moving to corporate risk, and as in the case of peripheral spreads, high-quality investment-grade corporate credit has performed decently by continuing to provide a more-resilient-than-expected market performance, especially given the current market conditions. In this situation, we believe that high-quality investment-grade (IG) corporates will continue to perform well in the current market environment (excluding certain banking-related bonds) and offer a decent pick-up vis-a-vis sovereign bonds. Despite the benign outlook, macro and financial stability-related market volatility may still lead to episodes of spread widening due to increasing default and rating-migration risks in the short run. This expected short-term volatility and widening episodes will, most probably, be exacerbated by the fact that credit risk seems to have remained under the radar despite increasing financing costs since the tightening cycle start last year. This has led to a divergence between economic expectations and credit-risk pricing throughout the rating spectrum. To avoid unnecessary volatility, and taking advantage of the spread pick up, we remain cautious on credit by ramping up quality and avoiding lower triple BBB ratings (and any HY). In numbers, we expect IG corporates to range trade from current values with a target of 150bps and 170bps for US and EUR IG corporate spreads, respectively, in 2023.

Finally, and despite our positive view on high-quality fixed-income instruments, we acknowledge that market participants will continue to negatively target banking and monetary policy-heavy sectors soon and for as long as policy expectations are not anchored. Because of this, we would refrain from targeting such assets tactically until the second half of the year (Figure 17).

Figure 17: US IG corporate spreads and bond volatility



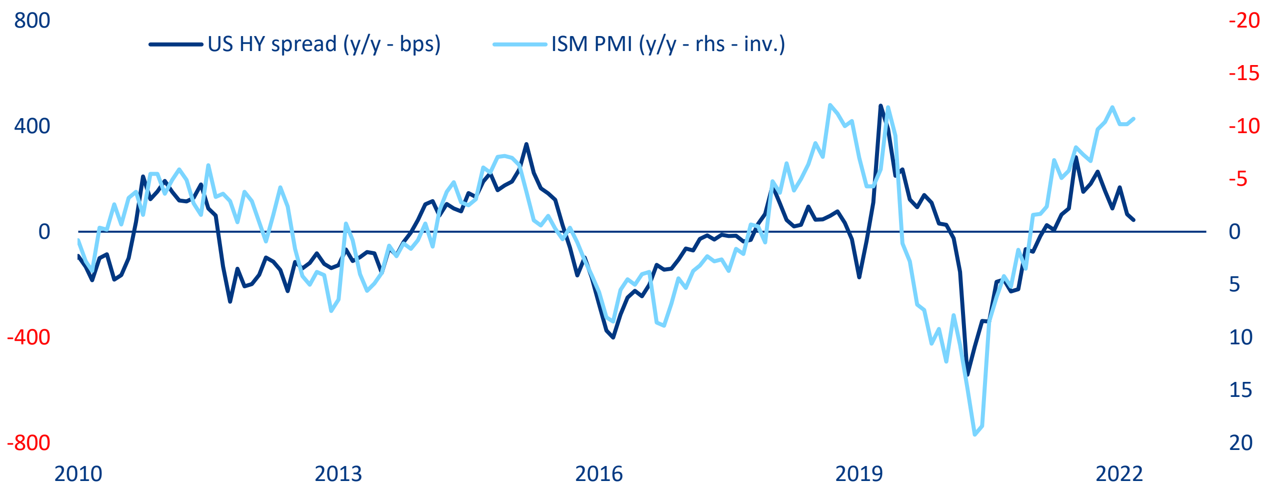
Sources: BofA, Refinitiv Datastream, Allianz Research

Third, markets continue to underestimate corporate credit risk

Continuing with the fixed income corporate theme, and despite the rather benign outlook for investment-grade corporate spreads, we acknowledge that, even with the latest widening, credit risk seems to remain mispriced and underrepresented, given the current economic and capital market conditions. This mispricing is not new and has endured since the beginning of the hawkish trail back in November last year. The credit mispricing is most visible in the divergence between economic leading/coincident indicators (ie. PMIs) and high-yield corporate spreads, which imply that credit spreads should be structurally higher when compared to current levels. This market mispricing can partially be explained by a combination of the global rush towards fixed-income instruments and the shortfall of fresh bonds that has been ongoing since the beginning of the year. Due to this market-economic mispricing, we tend to believe that the overall corporate credit market, especially for lower-rated corporates, may still fall victim to a sizeable market repricing even though debt-servicing capacity seems to remain at a decent level (Figure 18).

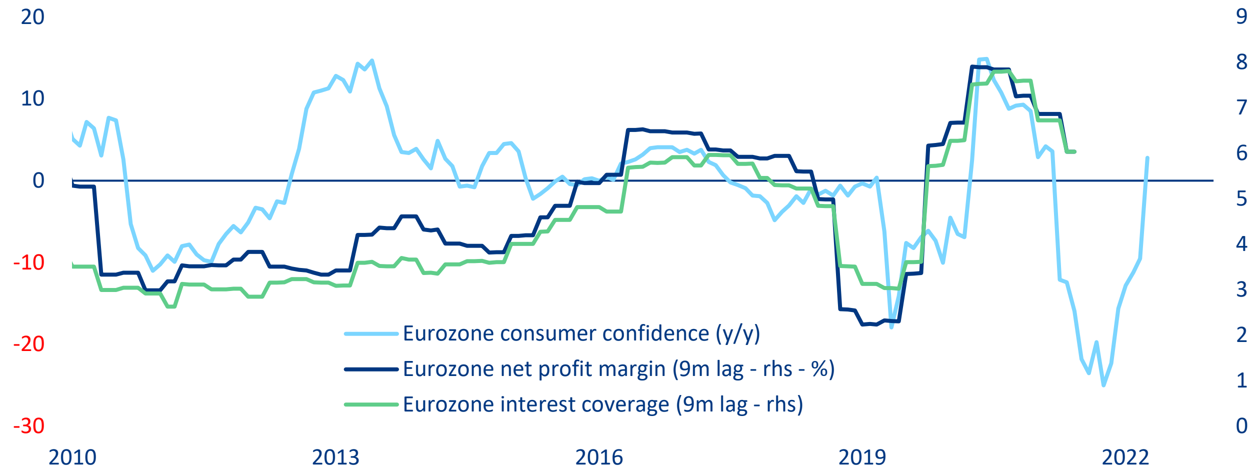
If the economy proves more sluggish than previously anticipated, corporate balance sheets and debt-servicing capacity will be under further pressure. As a result, we see the fundamental anchor value for both investment grade and high yield as structurally higher than current levels. At the same time, we believe that debt-servicing metrics will not reach levels that would imply a GFC or Eurozone-crisis type of scenario (Figure 19).

Figure 18: US HY spreads vs ISM PMI



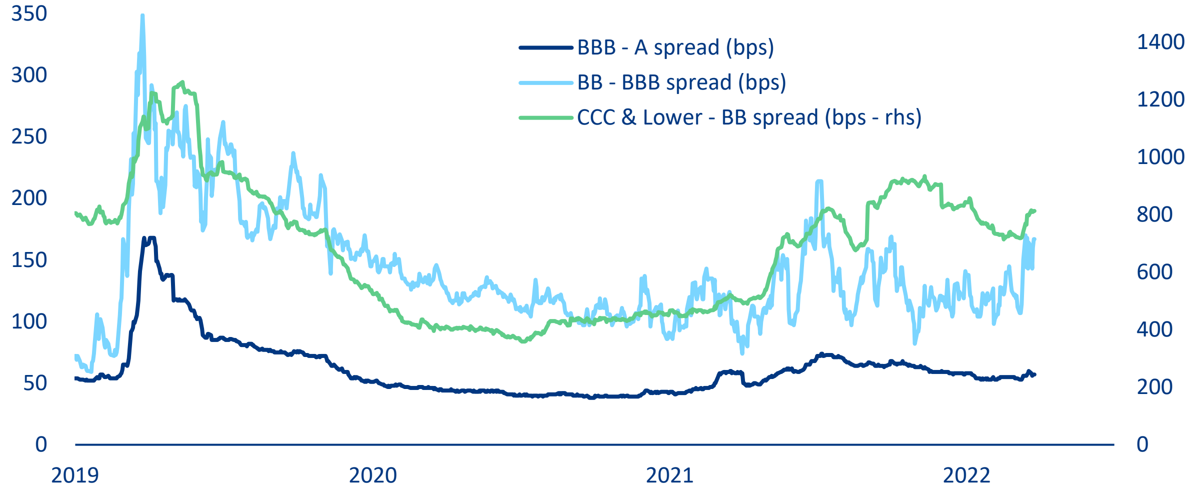
Sources: BofA, Refinitiv Datastream, Allianz Research

Figure 19: Eurozone corporate ratios vs economic sentiment.



Sources: Worldscope, Refinitiv Datastream, Allianz Research

Figure 20: US intra high-yield spreads (in bps)



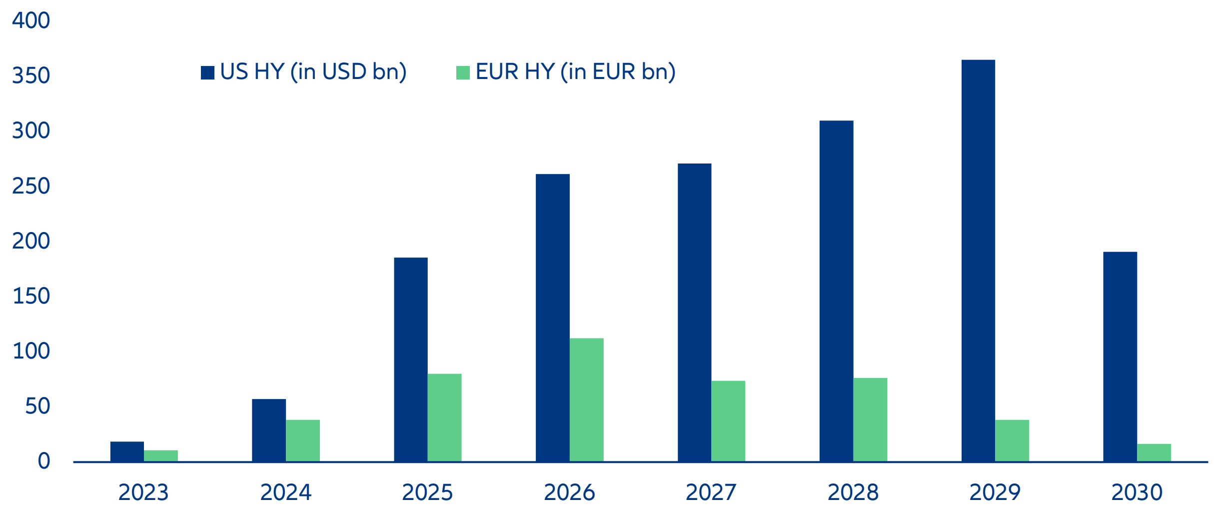
Sources: Worldscope, Refinitiv Datastream, Allianz Research

Even though, on aggregate, we still perceive a broad economic-corporate risk divergence, differentiation between investment grade and high yield is accelerating, with high yield, especially in the frontier between IG-HY, experiencing a structural market repricing. During this market wave, we expect the market reshuffle and repricing to continue as enduring high interest rates, exacerbated market volatility, declining money growth and deteriorating economic conditions will continue to dent corporate profitability and debt-servicing capacity in the future. As a result, we expect the winner-loser triage to continue and default rates and fallen angels to accelerate despite remaining at historically low levels (Figure 20).

On top of the structural credit mispricing, and as reminder of an upcoming risk for 2024 and 2025, should short-term interest rates remain at an elevated level into 2024, the refinancing wave for high-yield bonds may be at risk. This would especially be the case if both top and bottom lines continue struggling to accelerate due to a sluggish economic recovery and debt-servicing capacity is put under pressure (Figure 21).

To summarize, we still expect short-term pressures to launch HY spreads higher to the order of 50 to 80bps from current levels, reaching the 500-550bps mark by the end of the year. This makes the asset class risky both from a fundamental and tactical perspective.

Figure 21: High-yield maturity schedule

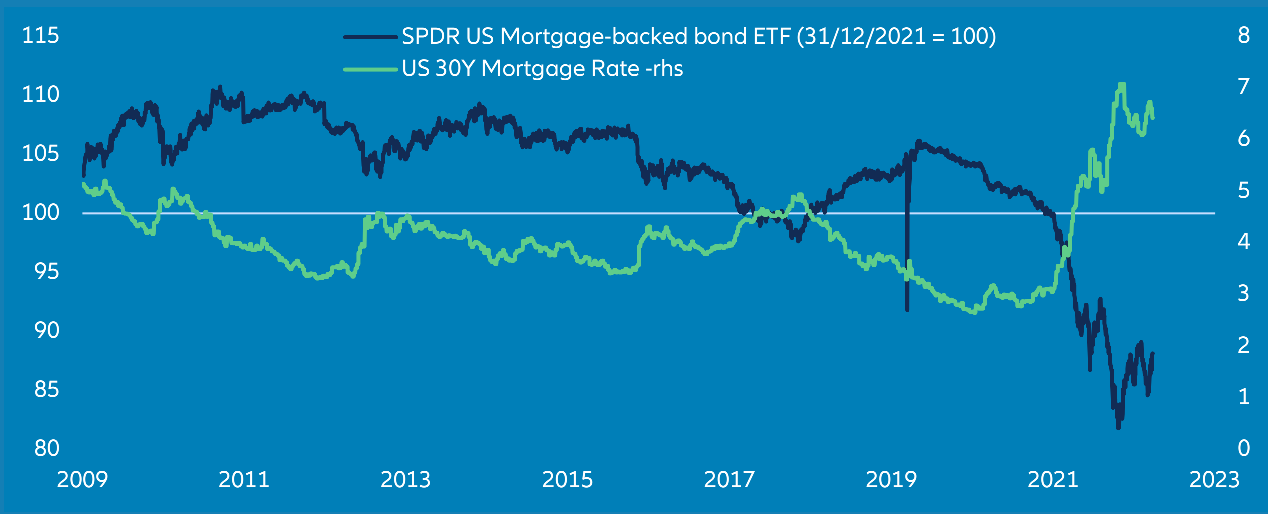


Sources: Refinitiv Datastream, Allianz Research

Box 4: Current situation in the mortgage-backed securities market

The rapid increase in interest rates has dealt a major blow to the MBS market. As was the case of some US banks, the portfolio holdings of assets such as US government bonds, or Freddie Mac MBS, have created a major problem due to the difference between their market and book values. Even when the expected Fed interest rate path has readjusted, and as long as there is no return to an ultra-low interest rate environment, mortgages from the 2010s are not going to recover their value and their holders should correctly assess their prices if they want to avoid unpleasant surprises when they need to sell (Box 4, Figure 1).

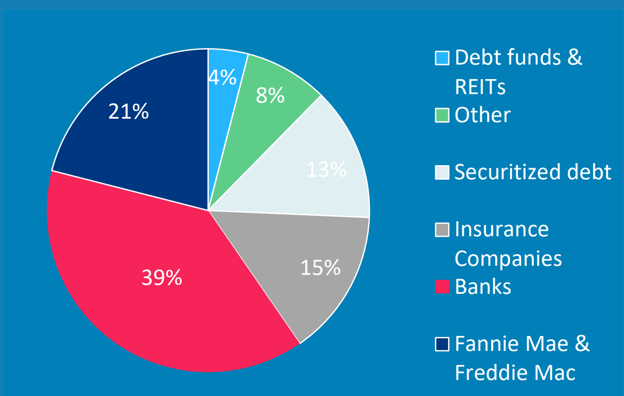
Box 4, Figure 1: MBS prices free fall as mortgage rates increased



Sources: Refinitiv, Allianz Research

Furthermore, the fundamentals trends in commercial property lending also point downwards. Number of deals is sharply down, appetite for further credit is now scarce (with a record commercial property debt maturing in the next two years) and higher borrowing costs. This is even more acute in the office sector, where the viability of working from home had affected demand even before the economic downturn. Thus, in addition to their securitized debt holdings, the commercial property loans portfolio of US banks are also a threat (banks are the most exposed, Box 4, Figure 2).

Box 4, Figure 2: 4.5 USD tn in commercial property debt; by owner

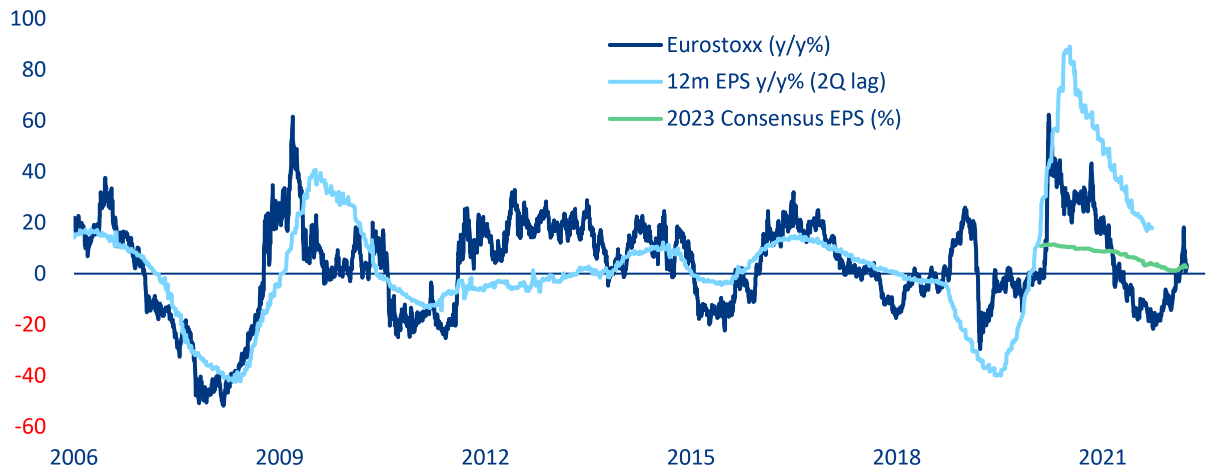


Sources: Mortgage Bankers Association, Bloomberg, Allianz Research

Fourth, equities will continue to be the ugly duckling
Equity markets, especially European equities, have shown great resilience since the beginning of the year, with most global markets posting positive returns on a year-to-date basis. In this regard, and despite the latest rate hikes continuing to hinder equity valuations, economic momentum and a better-than-expected earnings performance has prevented equity markets from crossing the red line. However, and due to the latest risk-off rotation on the back of banking accidents, the latest decline in equity prices has left certain markets (i.e. the US and UK) close to posting year-to-date negative results, making market participants doubt the fundamental resilience of equity markets.

Looking at fundamentals, and trying to remain as far away as possible from the recent market volatility, recent economic sentiment data prints indicate that equity fundamentals are still set for a profitability deterioration in the upcoming months, especially if a harsher-than-expected economic recessions materializes. In this regard, earnings expectations for 2023 continue to trend downwards, getting closer to 0%, suggesting that it will be a big effort for equity market participants to buy into a full-fledged above-trend equity-market recovery in 2023 for as long as a policy-pivot-driven change in short-term expectations does not artificially pump up equity valuations (Figure 22).

Figure 22: EUR equity markets and earnings expectations



Sources: Refinitiv Datastream, Allianz Research

In this context, we continue to believe that equity markets will continue playing around the -5% to +10% year-to-date trading range in the near future, with downside risks outpacing upside risk in the ultra-short-run. Moving into the second part of the year, we expect equity markets to stabilize on the back of a less uncertain economic and policy environment, with the first Fed rate cuts helping investor sentiment recover in sync with fundamentals. Having said that, in 2023, we continue to expect a +6% and +2% total return for EUR equities and US equities, respectively, indicative of the still better relative positioning – both in terms of relative and absolute pricing – of EUR equities versus US ones.

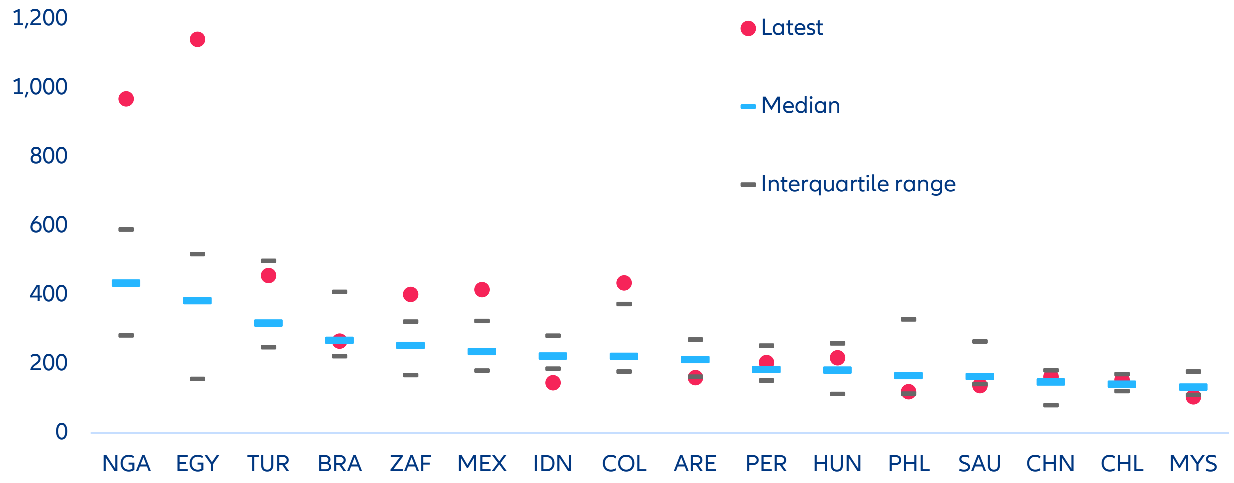
Fifth, mind the policy pivot in the emerging world

While our baseline scenario does not include a broad EM crisis, we remain cautious about the early-2023 tight pricing. The recent turmoil in the banking systems of advanced economies have caused a spread readjustment in line with our expectations, mainly driven by the embedded tightening in the system that has not been fully assimilated. We forecast a high volatility year (at least) which could create turbulence similar to what we saw in the worst moments of 2022. However, the year-end level for our benchmark index should not vary much from current levels (post-SVB peaks). The risks are not symmetric across countries, though. While the main default risks are concentrated in smaller developing economies and amid those with lower ratings, there are major countries – even commodity exporters – in a fragile situation due to a combination of factors (economic, financial and political) which could get in trouble should the downside scenario materialize (Figure 23).

Sovereign yields in local currency will likely end the year slightly lower, but with high variability across countries. Even if inflation is not under control, countries may need to ease financial conditions and support economic growth, thus pushing market rates lower. However, the risks of a stronger USD (i.e. currency risks and/or hedging costs) in a context of global financial stress are not to be disregarded for foreign investors.

Following the increase in borrowing costs, corporate debt problems in EMs are also starting to rise, although so far there is no widespread stress. Reopening in China will provide limited help to countries' distressed debtors.

Figure 23: USD sovereign spreads of selected EMs



Sources: Refinitiv, Allianz Research. The maximum historical depth available is used for each country spread.

What could go wrong?

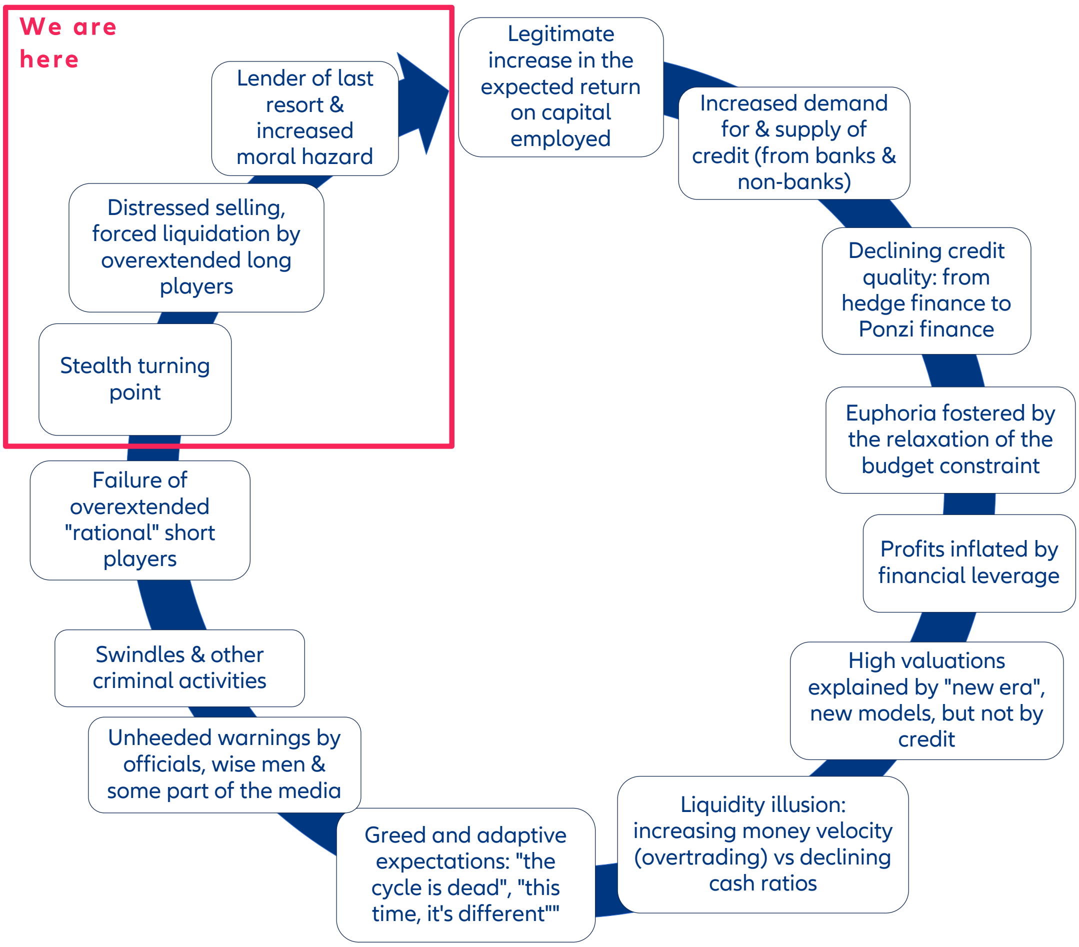
Downside risks dominate the current market sentiment as investors remain highly sensitive to the news flow. Any unexpected events such as a harsher-than-expected bank run, uncontrollable core inflation, increased geopolitical tensions or any other black swan could easily cause a structural downturn and erase any timid market correction. This could result in equity-market performance reaching minus double-digit returns for the second year in a row, cementing the market crisis label. Additionally, the still elevated US equity valuations, which offer less compensation than a one-year US T-Bill from an equity risk premium perspective, make the choice between equity and fixed income fundamentally challenging. This situation contrasts with Europe, where the equity risk premium indicates a small but positive compensation for taking equity risk.

In a world characterized by high volatility and uncertainty, market participants must recognize that the number of unknown factors outweighs the known ones. As a result, making significant bets can potentially harm overall portfolio performance. It is crucial to monitor the feasibility and likelihood of tail events, particularly market accidents, to ensure that investment strategies remain flexible enough to adapt to rapidly changing market conditions (Figure 24).

Last but not least, from a qualitative perspective and using Kindleberger's crisis clock as a base, 2023 appears to be marking the end of the business cycle clock that started ticking right after Covid-19. With the help of central banks, this cycle has uncovered market weaknesses and finally collected some market victims (i.e. Credit Suisse, SVB etc.). In this regard, we are between a quarter to twelve and 12 o'clock, with markets starting to show signs of tiredness that signal a turning point. This could be followed by some distressed selling, leading to central banks and governments stepping in and increasing the overall level of moral hazard.

This depiction of the current market cycle acknowledges the fact that, if managed incorrectly, the current market downturn could evolve into a really bad scenario. But if managed properly, we could see the start of a new market cycle, signaling the beginning of a fresh business cycle. In our opinion, 2023 will be a broken clock, oscillating between the end of the cycle and the beginning of a new one, with the market failing to commit to either side of 12 o'clock.

Figure 24: Fisher-Minsky-Kindleberger model



Source: adapted from Charles Kindleberger's "Manias, Panics and Crashes—A History of Financial Crises" (1978).

Table 4: Capital market scenarios

year-end figures	Last	Unit	2022	2023f	2024f
Eurozone			**2022**	**2023f**	**2024f**
Government Debt					
Policy rate (ECB deposit rate)	3.00	%	2.00	3.50	3.00
Policy Rate (MRO)	3.50	%	2.50	4.00	3.50
10y yield (Bunds)	2.19	%	2.6	2.40	2.20
10y EUR swap rate	2.95	%	3.1	2.70	2.50
Italy 10y sovereign spread	186	bps	213	190	170
France 10y sovereign spread	53	bps	55	40	30
Spain 10y sovereign spread	105	bps	109	100	90
Corporate Debt					
Investment grade credit spreads	172	bps	166	170	140
High-yield credit spreads	206	bps	494	540	460
Equity					
Eurostoxx (total return p.a.)	9.3 ytd	%	-12	6	7
US			**2022**	**2023f**	**2024f**
Government Debt					
Policy rate (upper)	5.00	%	4.50	4.75	3.25
10y yield (Treasuries)	3.40	%	3.83	3.70	3.30
Corporate Debt					
Investment grade credit spreads	152	bps	138	150	130
High-yield credit spreads	510	bps	479	510	440
Equity					
S&P 500 (total return p.a.)	3.3 ytd	%	-18	2	9
UK			**2022**	**2023f**	**2024f**
Government Debt					
Policy rate	4.25	%	3.50	4.25	3.50
10y yield sovereign (Gilt)	3.36	%	3.7	3.75	3.25
Corporate Debt					
Investment grade credit spreads	190	bps	192	200	160
High-yield credit spreads	645	bps	663	680	550
Equity					
FTSE 100 (total return p.a.)	1.7 ytd	%	5	3	7
Emerging Markets			**2022**	**2023f**	**2024f**
Government Debt					
Hard currency spread (vs USD)	317	bps	270	320	280
Local currency yield	6.6	%	6.50	6.7	6.5
Equity					
MSCI EM (total return p.a. in USD)	2.6 ytd	%	-19.7	5	6
Others			**2022**	**2023f**	**2024f**
Foreign Exchange					
EURUSD	1.089	$ per €	1.067	1.07	1.18
Commodities					
Oil Brent*	75	$ per Bbl	85	82	88
Natural Gas Dutch TTF*	41	€ per MWh	74	75	60

*yearly averages

Sources: Refinitiv Datastream, Allianz Research

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