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Market Strategy and Macroeconomics
Group Investment Management
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Economic and Market Outlook 2024

Skating on thin ice

Overview

Global growth is falling and is substantially below trend, yet 2023 has proven surprisingly resilient with the US economy managing to circumvent a much touted recession. Financial markets are embracing good news, not least of which has been plunging inflation, but cracks and fissures are increasingly evident in both economies and financial markets. With another war in the Middle East dragging on, the biting effects of elevated funding costs taking hold, and a year of critical elections ahead, risks abound – yet few are priced. While investors may be right in skating onwards against a perceived rose-tinted backdrop, we suspect that from a government, corporate and household perspective, challenges and volatility will prevail. Consequently, 2024 may be a year of skating on thin ice.

We suspect that the coming year will be defined by a few key developments. Will the US economy continue to evade recession, has inflation been truly vanquished, can China extract itself from its housing malaise, and, perhaps more intriguing and potentially far-reaching, what will be the outcome of the US presidential election? All this comes with the common global denominator of fiscal challenges, high debt loads, and elevated interest rates.

We have been surprised by the strength of the US economy in 2023. Resilience to higher rates through fixed rate mortgages and a hot labour market at the consumer level, combined with prior opportune refinancing and pricing power at the corporate level has kept activity and margins high. While this has been encouraging and highlighted the dynamism of the US economy, particularly as Europe headed towards recession and China underwhelmed, we suspect it is more a case of recession being delayed rather than cancelled. Key will be the labour market, which shows broadening signs of weakening, albeit from a very healthy level.

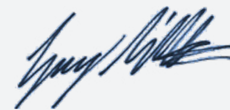
From the perspective of the US President, the risk of even a mild contraction next year bodes ill. History shows that the re-election of an incumbent president is challenging if growth contracts. Certainly the outcome of the election will shape many global issues, not least around climate initiatives and international relations. While the election process is still in its earliest days, polls currently reflect the challenges the Democrats face and suggest that fiscal policy will be kept accommodative to bolster activity. This is at a time when investors globally are more circumspect of rising deficits and increasing funding requirements. Fiscal challenges will also be at the fore in Europe, where Germany is fighting the self-imposed spending caps that are a part of its debt brake as the economy festers, while in Italy issues around debt sustainability have resurfaced given stagnant growth and higher funding costs.

While higher rates pose a challenge for funding globally, they have played their part as intended in undermining inflation. We had believed a substantial decline would occur in 2023 and that has largely played out. It is now critical that the stickier services and core components maintain their downward trajectory. The decline in inflation over the past year has been largely a function of base effects and increased supply. The coming year is likely to see the slower growth dynamic take over the baton, with rising unemployment and lower wage growth key drivers. Consequently, the higher-for-longer adage for interest rates is expected to move to true policy pivots as the year progresses and bolstering growth becomes the policy focus.

With global growth forecast to slip further in the coming year, China will not be immune. Although activity there has rebounded from the Covid period, it remains tepid with the property sector still haemorrhaging and consumer confidence in the housing market low. A patchwork of support measures have been unleashed and are showing tentative signs of stabilising the situation, but not yet resolving it. Local government finances are weak and developers are highly indebted. We still maintain that a financial crisis can be avoided, but further measures are required and this will not be a quick fix.

It is always easy to focus too much on global risks and underappreciate the opportunities being presented. Financial markets are typically quick to factor in the opportunities and have certainly been doing so given the substantial rally in both stocks and credit this year following a dismal 2022. With corporate margins still close to record levels in both Europe and the US, and Japan trying to reinventing itself at both the policy and corporate level, there is cause for cheer.

Artificial Intelligence will undoubtedly reshape the corporate world as well as societies and should not be underestimated. The structural shifts of higher defence spending and energy transition will likely lead to technological breakthroughs with wider applications. However, financial market pricing, particularly in credit, is rich with bankruptcies rising appreciably and very little risk premia on offer to compensate for any poor outcomes. Investors have a habit of being seduced for longer than is warranted, and while we acknowledge that there are fewer imbalances in both economies and markets than in the past periods, we do see volatility being high as some of the key questions for 2024 are resolved. Consequently, for the time being, investors and perhaps many other players in the global economy appear to be skating on thin ice.



Guy Miller

Chief Market Strategist & Economist

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Global

Outlook

- Global growth is set to moderate further given the lagging effects of past policy tightening
- Inflation is down but not yet out, with further declines expected in 2024
- A year of two halves for central banks, with rate cuts expected later in the year

Implications

- Government bond yields are likely to have peaked, though volatility will remain high for now
- Credit offers asymmetric downside with stocks and government bonds more attractive on a relative basis
- Stocks offer little risk premia and are vulnerable to weak growth and falling margins

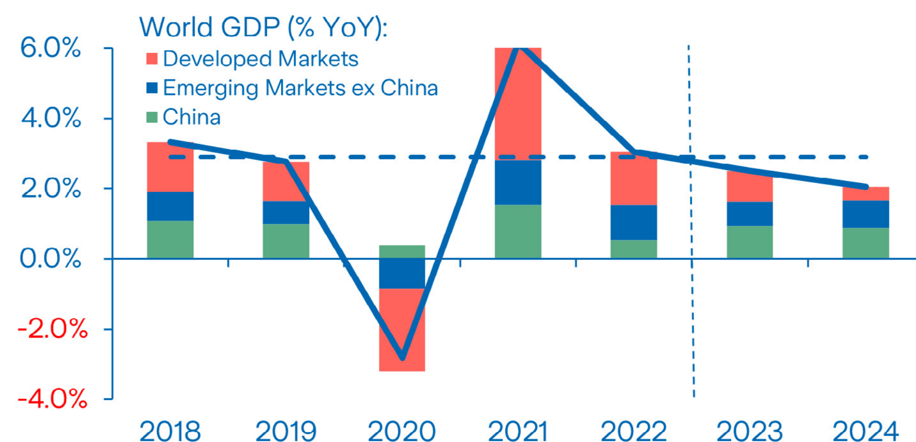
Risks

- Additional rate hikes from central banks
- A further deterioration in the fraught geopolitical backdrop
- Credit and stock markets suffer sharp falls in a deeper than expected recession

Another year with global growth below trend

Global growth fell to a below trend rate in 2023 and is currently tracking at a pace of around 2.5% for the year (valued at market exchange rates). This weakness masks a divergent growth picture, however, with strength and solid above trend growth in the US while Europe and China stagnate. Looking forward, momentum should become less divergent. The US economy is expected to slow markedly while the outlook remains subdued in other major regions, which will likely leave global growth substantially below trend again, at around 2% for 2024. The subdued near-term outlook is mainly a reflection of the lagging effects of policy tightening, which are yet to be felt in large parts of the economy. Indeed, households, businesses and governments have not yet seen the full impact of higher interest rates as they are still benefiting from the low funding costs that were locked in during and prior to the global pandemic. Over time, as debt is refinanced, elevated interest rates should become more restrictive for the economy.

Global growth set to weaken further



Note: Dotted line shows thirty-year average for global growth.
Source: ZIG, Bloomberg

At a sectoral level, services continue to see robust demand in the aftermath of the global pandemic, while manufacturing and global trade remain in a protracted contraction. We see weaker services activity in 2024 as demand normalises, while an improving tech and goods inventory cycle could bolster manufacturing momentum. Indeed, leading Asian trade data suggest that global trade may already have troughed, though any recovery is expected to be tepid given weak demand from major economies.

Inflation falls rapidly, but progress is uneven

Headline CPI has fallen significantly in 2023, led by disinflationary energy, goods, and food prices. Progress on domestically driven services inflation is still more modest, reflecting solid demand, tight labour markets and brisk wage growth. We expect inflation to fall further in 2024 as demand weakness constrains pricing power among businesses while wage growth should edge lower as job growth slows. Given this profile, inflation should be tracking at close to target towards the end of 2024, easing concerns around a permanent shift higher in inflation.

While the base case around inflation is benign, risk is asymmetric. Price and wage setting behaviours have shifted following the prolonged period of elevated inflation. This change is visible in the recent strong outcomes for pay settlements in the US and Europe and in the survey-based measures of inflation expectations that have drifted higher. In this environment, a return to less favourable inflation dynamics could potentially be triggered if demand rebounds, but also if there is renewed upward pressure on energy and food prices. This is why we expect central banks to remain vigilant, emphasising that rates will remain high until domestically driven services inflation is meaningfully lower or the growth outlook deteriorates more sharply. Indeed, a failure to do so would put further progress on inflation at risk.

The global rate hiking cycle has ended

Central banks maintained their hawkish stance through 2023, with further large rate hikes amid still elevated inflation. Looking forward, we believe that the global rate hiking cycle has ended. Nominal rates are in highly restrictive territory while falling inflation has put upward pressure on real interest rates. Near term, we expect central banks to remain on hold, maintaining the high-for-longer outlook to avoid a sharp and potentially premature loosening of financial conditions. The second half of the year should be characterised by a more decisive move towards an easing stance with rate cuts expected in key regions. Indeed, central banks in Latin America and Central and Eastern Europe have already started to cut rates, having kept them elevated and well above the rate of inflation for an extended period.

Risk to the outlook has become more balanced

While we continue to expect a further but moderate decline in global growth, risk to the outlook has become more balanced. A deeper and more severe decline in global growth is still not anticipated given limited financial market and economic excesses, and progress on inflation and an improved

energy situation has reduced downside risk compared to last year. At the same time, there is potential for growth to hold up better than expected near term, particularly given brisk fiscal spending, a resilient household sector, and stabilisation in China. However, the upshot of stronger near-term growth is that it could potentially lead to renewed upward pressure on interest rates and funding costs, which would weigh on activity more severely further out. Until inflation is decisively beaten, a stronger near-term growth outlook is unlikely to be sustainable given central bank and bond market responses.

Government bond yields are likely to have peaked, but volatility will remain high

Government bond markets have been extremely volatile in 2023. Fears around inflation and fiscal excesses drove yields higher, while concerns around the broader growth environment and banking sector issues triggered bouts of volatility and periods with slumping yields. Most notable, US Treasury yields breached new cycle highs in 2023, with the 10yr yield reaching 5% in October as investors demanded higher risk premia to hold long-term US debt. Since then, yields have moderated, led by encouraging news on inflation. In continental Europe, conditions have been more benign given the much weaker growth environment and less fiscal excess. In Japan, the yield curve control (YCC) framework has been adjusted, leading to a sharp rise in volatility following an extended period with suppressed dynamics that has implications for global bond markets.

Looking forward, the direction for government bond yields should be down as inflation continues to wash out of the system while the growth outlook remains challenged. There will be significant volatility around that trajectory, however, given the divergent forces that are still impacting the global economy and bond markets. Supply/demand conditions may also remain less favourable as fiscal deficits boost issuance while central banks are focused on reducing their bond portfolios. While yields will remain elevated and volatile in early 2024, we suspect that diminishing inflation fears and the beginning of a rate cutting cycle should allow yields to decline more meaningfully by the second half of the year. That said, we do not expect government bond yields to return to their pre-Covid levels given longer lasting changes that are underway in the global economy, with fiscal policy, energy transitioning, global trade, and the geopolitical backdrop at the fore. We see risk of weakness for peripheral Eurozone economies at the beginning of 2024 as nominal growth slows and fiscal concerns resurface amid discussions of formal deficit procedures that would render ECB support less likely. Our longer-term view is more sanguine given high political willingness towards European integration and mutual support in a difficult global environment.

Credit: risk-reward is skewed to the downside

Credit markets are at a crossroad with spreads largely pricing in a soft-landing scenario for the US economy, which is at odds with our view of a high chance of a recession in 2024. In the event that a US recession does occurs next year, we expect spreads to widen out sharply in H1 2024 and spend most of H2 2024 staging a recovery, ending almost flat for the year. That said, even if the soft landing priced by markets were to be realised, spreads would have limited upside as spread levels are close to 2021 tights. Given the asymmetry of risk/reward in credit, we prefer stocks to credit on a relative basis as they appear to have more symmetrical upside and downside potential.

The seeds of a credit downturn have already been sown with higher yields causing companies to draw down excess cash balances built up post Covid. Companies, particularly in the High Yield (HY) space, will find it harder to postpone issuance further and will end up refinancing debt at significantly higher coupons than existing funding costs. The weakest borrowers in the CCC segment are likely to experience the worst stresses, leading some to default. It is unsurprising therefore to see that US HY default rate climbed to around 5% by end of Q3, largely on track to meet our 7% forecast for 2023. What is truly interesting is that all these stresses and high default rates are happening even without a recession in the US, which is unusual.

Defaults are expected to remain elevated in 2024 and we project a further 5% default rate in US HY, not least due to the tight credit conditions created by banks, even though we do not expect a systemic banking crisis. Small and regional US banks are disproportionally exposed to the commercial real estate sector along with other credit exposures, hold underwater government bonds, and face stiff competition for deposits from money market funds. Hence, they are likely to be reluctant to expand lending aggressively.

On a more positive note, however, in both a soft landing and a recession scenario, rate cuts are expected next year. The cuts should support total returns in credit, driven by a rally in underlying government bond yields rather than in credit spreads. That said, given the uncertainty, investors are better off in government bonds rather than credit as the spread component of corporate bond yields is at the lowest level since the Global Financial Crisis.

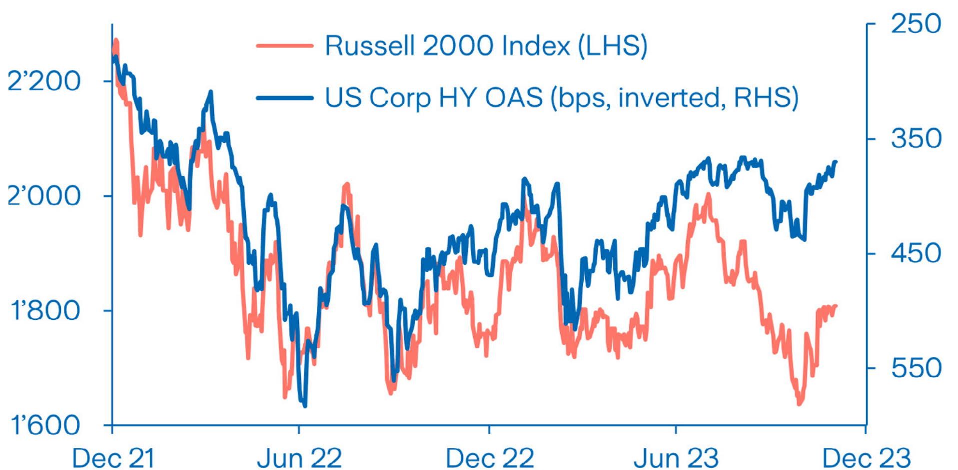
A bumpy ride for equities with modest gains expected in another volatile year

Global equity markets performed much better in 2023 than we had expected. Light investor positioning at the start of the year, a more robust growth dynamic than anticipated, and a precipitous decline in inflation were key factors. Indeed, the persistent move higher in policy and funding rates and a near US banking crisis early in the year proved manageable and many markets are posting double digit gains as the year end approaches. Notably, however, they remain below early 2022 highs. Equity investors have increasingly embraced the prospect of a supportive macro backdrop of further falls in inflation, easing monetary policy, and the circumnavigation of a US recession with stocks now offering little risk premia. Ultimately, 2024 returns will be determined by that recession outcome, which we still believe as probable, but acknowledge the return profile for stocks will be binary.

We see downside risk as high in the months ahead as recession risk starts to be priced back in by investors and earnings and margin expectations revised lower, the latter being close to record levels in some regions. With risk-free rates currently elevated and equity risk premiums at 20-year lows, investors have an attractive cash alternative to stocks that can buy them time to determine that key economic outcome. Despite the macro challenges, over the course of what we expect to be another volatile year, we think modest gains in equities are likely, albeit back-end loaded.

The composition of the US stock market is still favoured over the long run, with exposures to key technologies and strong business models offering superior returns. That noted, trading opportunities are expected to arise in some emerging markets in both Asia and Latin America in 2024, while Japan may stay in vogue for some time longer, though we expect yen appreciation to curb sentiment as the year progresses. Should the US economy prove to be more resilient than we expect and inflation continue to moderate, equities are likely to breach 2022 highs as momentum builds with another year of double-digit returns possible. Currently, however, this seems unlikely.

Credit seems expensive relative to stocks



Source: Bloomberg

US

Outlook

- Growth is slowing rapidly and the risk of a recession in 2024 is very high
- Inflation continues to fall and is expected to move back to target over the course of the year
- The Fed remains hawkish but will cut rates as the slowdown becomes more evident

Implications

- Bond yields have peaked but the risk premium will not fall back to pre-Covid levels
- Credit is vulnerable and we prefer stocks instead, but Muni and ABS should be resilient
- Equities are likely to suffer further setbacks as valuations do not reflect growth headwinds

Risks

- Inflation reaccelerates forcing the Fed to tighten policy even further
- Growth falls more than expected as the negative feedback loop exacerbates the fallout
- The Fed cuts sooner and more aggressive than expected, managing a rare soft landing

Consumer spending has been resilient but is likely to weaken going forward

The US economy has shown remarkable resilience in the face of the most aggressive monetary tightening in decades. GDP growth started at a relatively modest pace at the beginning of 2023 but picked up over the summer despite an increasingly hawkish Fed and rising global headwinds. Consumer spending in particular was holding up better than expected. Excess savings that had accumulated during the pandemic lasted longer than anticipated and households were partially shielded against higher interest rates as many of them had used the period of very low yields to refinance their mortgages at fixed rates.

Households' total debt service ratio dropped to the lowest on record in 2021 before rebounding to pre-pandemic levels. Interestingly, while debt service costs on consumer loans have risen to the highest since the financial crisis, the ratio for mortgages remains just below the levels seen in March 2020. Nevertheless, higher mortgage rates and soaring costs for consumer credit will increasingly weigh on consumer sentiment and spending. A significant pickup in delinquency rates for credit card loans in recent months reflects the growing headwinds for the US consumer.

Tighter monetary policy will continue to weigh on the growth outlook

Some sectors feel the impact of tighter monetary conditions and higher financing cost quite strongly. While low yields and solid consumer demand have supported the business sector, corporate bankruptcies are now rising at an accelerating pace. The housing market has been under pressure for some time now. Existing home sales fell to 3.8mn in October 2023, the lowest level since 2010, with the National Association of Home Builders' market index pointing at further headwinds. The Mortgage Bankers Association's mortgage application index recently fell to the lowest in almost three decades, showing that potential home buyers are remaining on the side-lines.

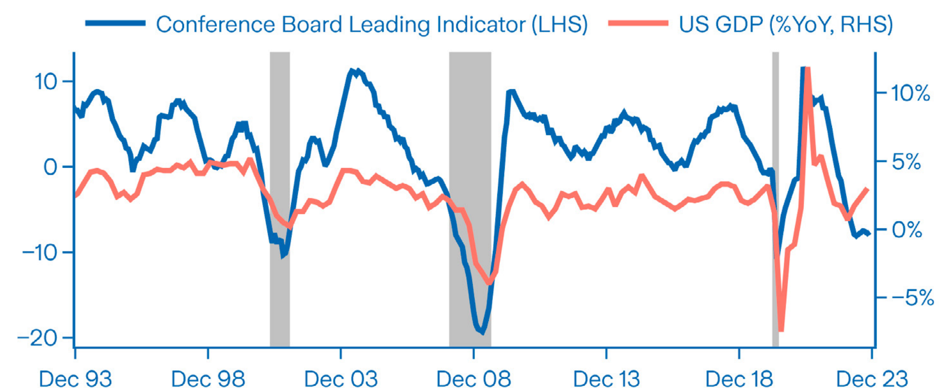
The manufacturing sector is also suffering from weak demand, both domestically and globally. The ISM Manufacturing Index has been in contractionary territory for more than a year as of November 2023, with weak new orders and softer employment conditions signalling further challenges ahead. For much of 2023 the weakness in manufacturing was more than compensated for by a thriving service sector. The pace of service activity slowed markedly at the beginning of the fourth quarter, however, as households have become more reluctant to spend. Momentum is slowing substantially in the fourth quarter and growth is becoming increasingly fragile. The Conference Board's basket of leading economic indicators, including the development of new orders, building permits, hours worked, consumer expectations and credit conditions, keeps pointing to a contraction in the months ahead.

Cracks in the labour market are widening

The growth environment is expected to deteriorate further in 2024 with a significant risk that the economy is falling into recession. The employment situation is becoming more challenging, and we expect unemployment to move meaningfully higher in the quarters ahead. At 3.9%, the unemployment rate remains low for the time being, but has steadily risen from its low of 3.4%. Vacancies are still elevated but are far below their peak levels, and jobless claims are starting to pick up momentum. With tighter financial conditions becoming an increasingly severe drag on the economy, more and more cracks are appearing in the labour market. While unemployment is only rising slowly the number of vacancies is rapidly falling and although the number of new payrolls has been growing at a solid pace in recent months, total hours worked by all employees are now back in line with pre-pandemic levels. In addition, overtime in manufacturing has recently fallen to multi-year lows, a potential sign of a weakening employment situation more generally.

Weaker employment conditions are also reflected in the lowest quits rate since January 2021 and workers are finding it more difficult to find a job. Companies' hiring intentions have fallen back to pre-Covid levels. Finally, although the total number

Leading indicators keep signalling growth risks for the US economy



Source: Bloomberg, grey bars indicate recession periods

of payrolls keeps rising, the demand for temporary workers has been falling continuously since its peak in March last year. Historically, this has been a reliable indicator of slowing growth and a looming recession.

Reduced wage pressure will help to lower service inflation

The slowdown in the labour market will help to further mitigate wage pressure. Growth in average hourly earnings slowed to 4.1% in October 2023, down from almost 6% in March 2022. Encouragingly, on an annualised basis, average hourly earnings were roughly in line with the Fed's inflation target for the last three months. The Atlanta Fed wage tracker showed overall wage growth of 5.2% YoY in October, down from 6.7% a year ago. Interestingly, the gap between wage growth for workers who switched jobs and for those who stayed has narrowed markedly. In other words, despite a still elevated number of vacancies relative to the number of employed workers, switching jobs does not bring a significant pickup in wages on average anymore. Firms' willingness to pay higher wages to lure away workers seems to have faded substantially as the business outlook is weakening.

Reduced wage pressure will also allow the Fed to take a less hawkish stance as there are fewer reasons to worry about a potential wage-price spiral. Price pressure is continuing to fade throughout the economy. Headline inflation has fallen rapidly from a peak of 9.1% YoY in June 2022 to 3.2% YoY in October 2023 and is expected to fall further in 2024. Core inflation has been more stubborn but also receded to 4.0% in October, the lowest in two years, helped by a slowdown in shelter costs and other service components. Business surveys show that firms are increasingly reluctant or unable to raise prices as consumer demand is weakening and competitive pressure is rising. On a positive note, input costs are also growing at a slower pace, reducing the need to pass on higher costs. Weaker economic data and falling inflation rates are pushing down yields as it becomes increasingly likely that the Fed is done with hiking.

The Fed is expected to cut rates in 2024

So far, the FOMC has not been willing to concede that it has done enough to bring inflation back to target, keeping open its options to tighten policy further. Nevertheless, given our view on growth and inflation we think that federal fund rates have reached their peak and the Fed is likely to cut rates in the first half of 2024. The lower yield spread relative to other currencies is expected to weigh on the US dollar.

Longer-term rates are also expected to fall as growth and inflation soften, particularly if the economic environment deteriorates markedly as we expect. However, given a soaring budget deficit and worries regarding fiscal sustainability, investors have built in a higher risk premium that is unlikely to disappear anytime soon. The deficit is already significantly above the usual non-recessionary levels and the government will continue to issue a large amount of new debt. At the same time, important buyers, including China, Japan and the Fed, are less eager to soak up the additional bonds. On the contrary, the Fed continues to rapidly shrink its balance sheet with the effect of reducing the money supply. This is likely to create further headwinds for both equities and bonds.

Credit is vulnerable with both Investment Grade and High Yield pricing an optimistic outlook

US credit markets are pricing in a soft-landing scenario with spreads of both Investment Grade and High Yield much closer to the tights of 2021 rather than the levels consistent with a recession. While we believe the risk of a recession is high in 2024, even in the scenario of a soft landing, the upside in credit is quite limited and for this reason we believe stocks and bonds offer better value than credit on a risk adjusted basis.

Defaults have risen sharply in 2023 and we expect 2024 to see a continuation of defaults given tight credit conditions and elevated prospects of a recession. Rising funding costs and the fragile condition of the banking sector is likely to keep the pressure on the most vulnerable credits. While we do not expect a systemic US bank crisis, the pressure on banks from rising delinquencies in credit exposures and commercial real estate loans, as well as stiff competition for deposits and eroding margins, should cause banks to keep lending conditions tight. We are more constructive on US ABS where spreads have already widened, and while delinquencies and defaults are expected to rise, structural protections in senior bonds are likely to keep investors immune to impairments. We also expect municipal bonds to outperform as funds should attract inflows due to a more stable Treasury yield environment, while municipal revenues are expected to stay resilient even in a recession.

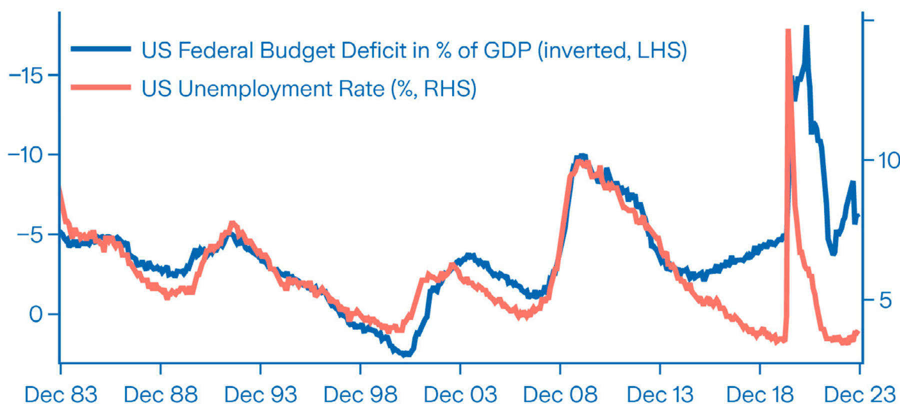
Stocks are not cheap and look vulnerable given the deteriorating growth outlook

The stock market has benefitted from widespread pessimism and very low holdings at the beginning of 2023. However, investors substantially increased their holdings over the course of the year as growth worries moved to the background and the economy proved to be more resilient than expected. Falling inflation rates and the prospect of lower interest rates have supported the stock market as investors are betting on a soft landing. Growth stocks in particular benefitted from a lower yield environment, significantly outperforming the broader market. Both the Russell 2000 which is comprised of smaller companies as well as the equal-weighted S&P 500 struggled to move into positive territory in 2023. Meanwhile the tech-heavy Nasdaq soared by more than 35% as of November. The large technology companies' strong performance also boosted the S&P 500 to outperform most of its peers.

However, given the widening cracks in the economy, expected pressure on margins and earnings, as well as an unnecessarily hawkish Fed, the equity market looks vulnerable. Earnings estimates look too optimistic given the deteriorating growth outlook and will probably have to be revised down. High valuations do not reflect the growing headwinds and look even more elevated once overly optimistic earnings expectations are taken into account. Considering that the earnings yield on the S&P 500 is at about the same level as the risk-free rate, equities do not look very attractive at the moment.

Receding inflation, lower growth and reduced wage pressure will allow the Fed to take a less hawkish stance, but for now the central bank is unwilling to signal lower rates or a reduced pace of quantitative tightening. However, the longer the Fed maintains its hawkish stance waiting to be fully convinced that inflation is really on a sustainable track towards its target, the higher the risk of damaging the economy and financial markets more than needed. Once negative growth momentum gains traction through higher unemployment, rising delinquencies, corporate defaults and deteriorating sentiment, there are increasing risks that the economy will contract before resuming its longer-term trend growth rate. Therefore, a soft landing of the economy seems rather unlikely in our view.

The budget deficit is soaring despite very low unemployment



Source: Bloomberg

UK

Outlook

- The growth outlook is muted for 2024 as consumer spending faces further headwinds
- Inflation rates continue to fall, helped by a slowdown in wage growth
- The BoE will start to loosen its policy once inflation reaches a sustainable path to target

Implications

- Interest rates have peaked, but an uncertain fiscal outlook continues to weigh on bonds
- Credit to be vulnerable in H1 2024, while ABS prospects also appear dim
- Equities are not expensive and should benefit from the prospect of looser policy

Risks

- Inflation and wage growth remain elevated and force the BoE to keep policy tight
- Negative momentum in the labour market accelerates, leading to a severe contraction
- Falling inflation and solid wage growth trigger a strong pickup in consumer spending

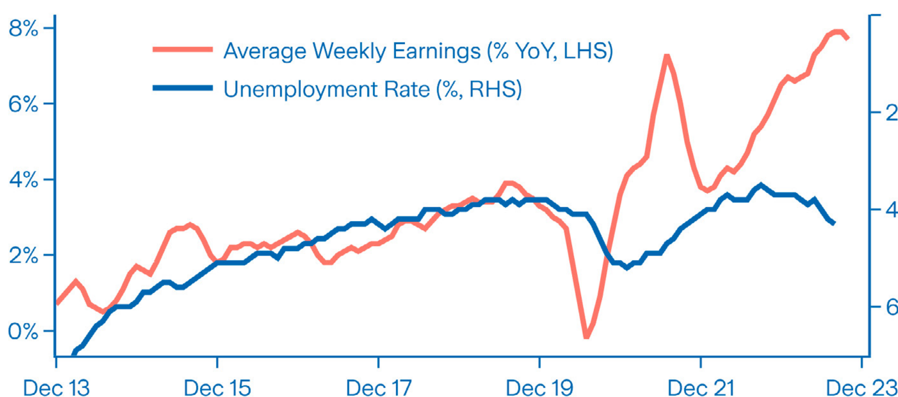
The UK economy is not growing
The British economy is facing increasingly severe headwinds. While GDP grew 0.3% QoQ in the first quarter of 2023 and 0.2% QoQ in second quarter, it came to a standstill in Q3. In fact, it was only thanks to a positive trade balance that the economy did not contract. Both consumer spending and business investment fell in the third quarter and the outlook is challenging for the coming quarters too. Business surveys show that firms remain cautious. Manufacturing remains in contraction with the PMI at 46.7 in November. Service activity is holding up a bit better with the PMI at 50.5. Taken together the surveys show that the economy was basically stagnant in November.

The surveys also reveal that cost-of-living pressures, high interest rates and weak consumer confidence are factors that are holding back customer demand. New orders decreased to the greatest extent since November 2022, underlining the challenging environment. In addition, while trade was an important driver of growth in the third quarter, export sales came under pressure for both manufacturing and services.

Rising unemployment reduces wage pressure
In line with a weak growth outlook, hiring activity was relatively subdued in the fourth quarter. Employers are hesitant to commit to permanent new hires while demand for temporary help was roughly unchanged, indicating that firms are looking for some flexibility in their workforce. There are increasing signs that labour market slack is rising. The availability of workers is increasing due to redundancies and restructuring efforts. The unemployment rate rose markedly over the course of the year to reach 4.3% in July, significantly above the low of 3.5% reached in August 2022.

A softer employment situation will reduce pressure on wages. Starting salary inflation slowed to the lowest in almost three years. Broader wage measures are still elevated and significantly above the Bank of England's comfort level, however. Weekly earnings excluding bonuses were 7.7% higher in August compared to a year ago. That is only marginally lower than in July when wages were growing at the fastest rate in decades. Solid wage growth and falling inflation have resulted in robust real income growth, which helped to support consumer spending through much of the year.

Wage growth is likely to fall as the labour market weakens



Source: Bloomberg

Consumer spending is facing headwinds, though tax cuts may mitigate the impact
Despite very robust wage growth households have become more reluctant to spend in recent months. Retail sales fell both in September and October, reflecting more cautious consumers. Households will be relieved that inflation is finally falling, bringing down the cost of living. However, still elevated mortgage rates and a deteriorating employment outlook is likely to weigh on consumer sentiment and spending for the time being.

The personal tax cuts announced by Chancellor Hunt in his Autumn Statement will help to support consumer spending at the margin although part of the tax benefits is usually saved, particularly in more uncertain times. Gilt yields rose in the aftermath of the announcement as investors are concerned about fiscal sustainability. A tax-driven pickup in consumer demand could defer the Bank of England's decision to cut rates thereby offsetting part of the positive economic impact. The second important tax announcement in the Autumn Statement was the decision to make the full-expensing tax relief for investment permanent. This measure will not have an immediate impact on the economy but should lift business investment in the longer run, which would in turn help raise the disappointingly low productivity growth seen in recent years.

The housing market is suffering from high interest rates
One sector that is strongly affected by higher interest rates and tighter financial conditions is housing. Home sales fell markedly at the beginning of 2023 and are still below pre-pandemic levels. House prices have been under significant pressure, falling more than 5% YoY in summer 2023, the steepest drop since 2009. Mortgage rates soared to the

highest level since the financial crisis as the BoE tightened its policy. Given that the average duration of a mortgage in the UK is shorter than in many other regions this led to a significant headwind to households' purchasing power, particularly since general living costs have soared, too.

Although mortgage rates have started to fall recently many households will still have to refinance their mortgages at higher rates. In combination with weaker employment conditions this is likely to lead to higher delinquencies and defaults. Nevertheless, despite these elevated risks we do not expect a severe real estate crisis. The UK mortgage market has evolved considerably since the global financial crisis, with significant changes in prudential rules and the lender's code of conduct leading to more disciplined and stricter lending criteria.

Lower inflation and weak growth will lead to further falls in bond yields

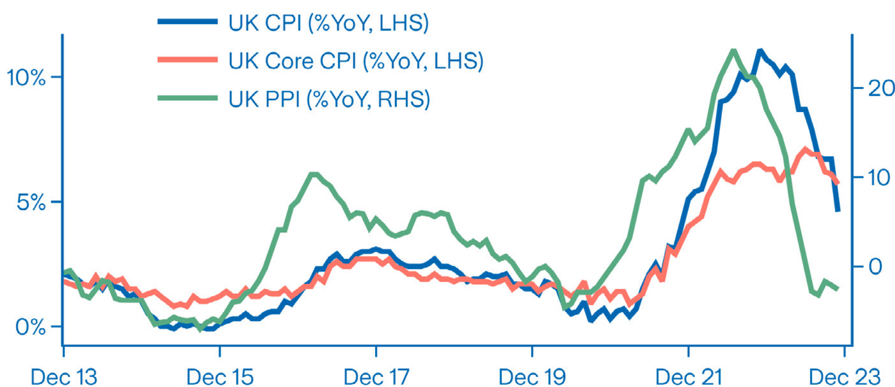
Interest rates are likely to have peaked, but the Bank of England is keeping a hawkish bias for now. Inflation rates are falling rapidly but remain significantly above the BoE's target. Driven by a substantial fall in energy prices, headline inflation dropped to 4.6% YoY in October, down from 6.7% YoY in September while core inflation slowed from 6.1% YoY to 5.7% YoY. Price pressure is likely to fall further over the course of the year as global economic activity and demand remain muted. Service inflation is stickier so the slowdown in core inflation will continue to lag the broader development. Receding wage growth will help to bring down service inflation, but it will take some time until the BoE can be convinced that price pressure is sustainably moving back to target. Nevertheless, the central bank is unlikely to wait until inflation is truly back to target. A continuation of recent trends combined with further weakness in the labour market should be enough to trigger the first rate cuts in 2024.

Gilt yields rallied more than most of their developed markets counterparts in the first half of the year. The spread between gilts and Treasuries rose to the highest level since 2009 over the summer as investors worried about stubbornly high inflation rates and a rising budget deficit. That has dramatically changed with the spread reverting back to negative territory in September. Investors will continue to demand a higher risk premium than before the pandemic, particularly given the latest tax cut announcements and rising gilt issuance. Nevertheless, interest rates have room to fall further if inflation rates keep receding and the economic outlook remains challenging.

Credit is vulnerable while UK Mortgage ABS to suffer from higher delinquencies

Credit spreads appear expensive in sterling credit when compared to the European credit markets. The spread differential is currently almost non-existent despite the lower quality credit market in UK historically trading at wider spreads to Europe. Given the growth outlook coupled with a high chance of a US recession, which would cause global credit weakness, we believe sterling credit spreads have notable downside, making risk-reward unattractive. Even financials are trading at tighter spread levels than European financials, despite the fact that the risks in the UK banking sector are not lower than those in European banks. Tight credit conditions, higher funding costs in a refinancing, along with a muted growth outlook imply that prospects for most vulnerable companies remain dim. Even in consumer credit, higher mortgage rates and cost of living, a likely economic slowdown, and a marginal decline in house prices should push delinquencies and defaults higher. ABS spreads should remain under pressure, and we expect more tiering between issuers, especially in the Buy-to-Let and Non-Conforming segments of the Residential Mortgage-Backed Security (RMBS) market. That said, while we expect weakness in H1 2024, spreads should recover later on as rate cuts gather momentum and the US recession appears to be in the rear-view mirror, together with cheaper valuations.

Headline inflation is falling rapidly



Source: Bloomberg

Stocks are not expensive but are being held back by a muted growth outlook

UK equities have struggled through large parts of 2023, falling behind most of their developed market peers. In November, the FTSE 100 was basically at the same level as at the beginning of the year while other markets in the US and in Europe enjoyed double-digit gains as they benefitted from falling inflation rates and the outlook for less hawkish central banks. The FTSE 250, which includes smaller and generally more domestically focused companies, fared even worse as the economy barely grew in recent quarters and firms faced rising input costs. While other parts of Europe faced similar headwinds UK companies also had to cope with a significant widening in yield spreads relative to the US and the Eurozone.

Given the modest growth outlook UK equities will probably continue to struggle in the coming months. However, valuations are attractive compared to other markets as economic risks are already priced in to a large degree. Further falls in inflation, the prospect of looser financial conditions, and an improving growth outlook later in the year should begin to attract global investors, not least given attractive dividend yields.

The UK economy has hardly grown for the last six quarters as domestic and global factors have weighed on economic activity. Headwinds are likely to persist for the coming quarters as financial conditions remain tight and the global outlook is still muted. The risk of a recession is high. While inflation rates will continue to fall and the labour market is softening, consumer demand is still facing ongoing headwinds. Once inflation rates are on a sustainable path towards target and the risks of a persistent wage-price spiral dissipate, the Bank of England will start to loosen its policy, which should help to reignite economic momentum. Nevertheless, the growth outlook for 2024 is modest.

Eurozone

Outlook

- Economic growth to stagnate as previously strong performers converge on a slowing Germany
- No green shoots in sight for low trend growth, productivity needs a boost
- Although the ECB will initially be reluctant to cut rates, weak activity and benign inflation justifies easing in H2

Implications

- Eurozone equity markets will end the year positively given reasonable valuations
- Bond yields will fall on the year, but investors have already factored in significant ECB cuts
- Sovereign spreads will be wider in the near term on growth and deficit concerns with support from policy easing in H2
- High Yield Credit spreads to widen while IG credit is better valued

Risks

- The lagging effects of policy rate hikes worsen the poor growth outlook
- Structural changes lead to persistent higher inflation and employment, leaving rates high
- High pessimism increases the hurdle for new negative information to move markets

Stagnations

With Eurozone GDP growth negative since Q3 2023 and leading indicators across the bloc consistent with a further contraction ahead, we see a recession into the first half of 2024. The base case is a mild slowdown before a slight recovery towards year end. We arrive at this conclusion by seeing headwinds for all major components of GDP throughout 2024. Consumption growth should struggle amid weakening labour markets, while both consumption and overall investment should be impacted by the continued high interest rate environment. Government spending, so crucial throughout the recent series of shocks, should be less supportive as emergency provisions are scaled back—although overall public spending levels will remain high. Uncertainties abound on the specifics of Next Generation EU (NGEU), the EU's EUR 800bn centralised, post-Covid fiscal support package. However, this funding source remains a positive growth driver that will partially offset national government budget tightening. Net trade is also unlikely to provide support for the economy given increasingly structural global headwinds and the Eurozone's struggle to be competitive internationally. Fundamentally, we see low-trend growth in the absence of evidence of improving productivity growth.

Convergence in weakness

Germany was the most significant contributor to Eurozone economic weakness in 2023, and while we see stagnation there, we also see convergence to the downside across the bloc. Amongst the four largest economies, we believe the relative ranking for growth rates in 2023 will carry through 2024: Spain at the front of the pack, followed by France, Italy, and then Germany. There is room for further growth in Spain, although substantially diminished from 2023. The political situation there presents some downside risks, particularly around policy consistency given Sanchez's slim parliamentary majority. In France, public sector resilience and a favourable energy mix diminished headwinds in 2023, but rising unemployment and pressure to consolidate fiscal expenditures will weigh on the economy in 2024. Lastly, Italy's economy will see less of a positive contribution from tax-incentivised construction and adjacent spending. Italy's economy stagnated in H2 2023, and we expect weakness to persist.

The last mile of inflation, with hurdles yet to jump

We expect inflation to decline to just above the ECB's 2% target by the end of 2024, allowing the central bank to focus its attention on the struggling real economy. This is primarily driven by our expectation of weakening growth and rising unemployment, alongside slowing wage growth and fewer firms increasing prices. The path there is more complicated than a simple decline, however, and uncertainty is elevated around the energy outlook. At the beginning of the year there is scope for unwelcome surprises in headline inflation. The peak of energy disinflationary base effects is behind us, while a fall in the price of goods from exceptionally high levels is also less likely to reduce inflation measures going forward. Despite these disinflationary tailwinds fading, the inflation outlook should normalise towards target as demand falters throughout the year.

Labour market cracks

The employment situation in the Eurozone has been undeniably strong into the end of 2023. We anticipate this changing substantially throughout 2024 and already see early signs of weakening. Employment growth, which impressively returned to its pre-pandemic trend, should slow as job vacancies continue to drop and wage growth moderates. While public sector roles, which have disproportionally contributed to employment gains, will likely be more insulated, we see weakness across the private sector. Although both public and private sector unions have continued to request significant pay increases throughout 2023, we see these demands waning in proportion to a weakening labour market as the year unfolds.

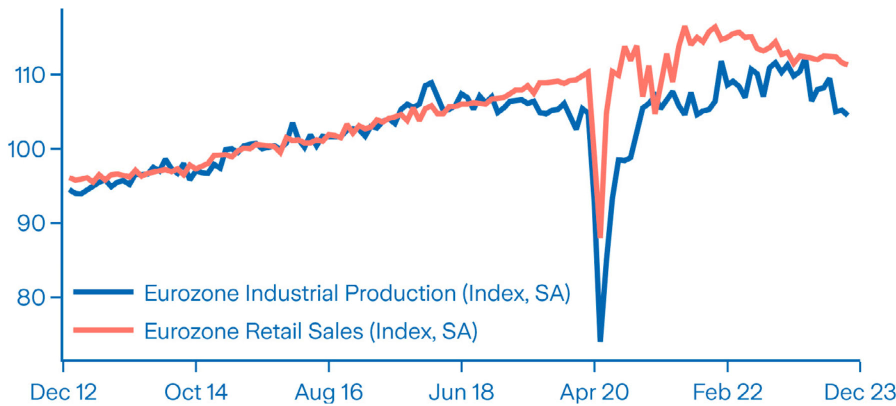
The ECB to reluctantly pivot, with pushback along the way

In our view, the ECB is likely to cautiously ease policy in late 2024. We see three 0.25% interest rate cuts coming in the second half of the year as growth and employment concerns outweigh already-slowing inflation. However, we see increased scepticism regarding the usage of 'non-conventional' policy tools, such as Quantitative Easing (QE), and a high reluctance to move back to a negative interest rate environment.

Pessimism is very high

Despite our forecast being more downbeat than consensus numbers, the risks are not overwhelmingly skewed to the downside. Pessimism about the economic situation in the Eurozone is high and an increasingly broadly held view in the investor community. This is a large factor in our thinking about the outlook for Eurozone asset prices. While a deeper recession is clearly possible as monetary policy continues to bite, the clearest upside risk comes from stronger private consumption driven by possible employment resilience and real wage increases. Secondly, although the energy situation remains uncertain, with risks of price spikes into winter, progress has been made on supply resilience. Current gas storage levels for Europe as a whole are considerably above long-term averages. Fears regarding the energy situation have become less about acute industrial shutdowns and household blackouts, and more about disadvantaged international economic competitiveness.

Retail sales and industrial production are back to 2019 levels



Source: Bloomberg, Eurostat

Government bonds to do well, but yield levels are not compelling

Eurozone bond yields rose considerably throughout 2023. The pace of this rise was slower than that of developed market peers, particularly the US, as the Eurozone growth outlook deteriorated and the inflation picture looked weaker throughout the year. We see plenty of reasons for government bond yields to move lower in 2024, particularly as the ECB shifts more decisively towards easing. However, Eurozone yield curves are already pricing a significant expectation of policy easing over the course of 2024, which diminishes the upside potential for bonds. Outright yield levels are also less attractive than various peers, even as the reasons behind this (namely: lower long-term growth and the inflation outlook) are likely to persist.

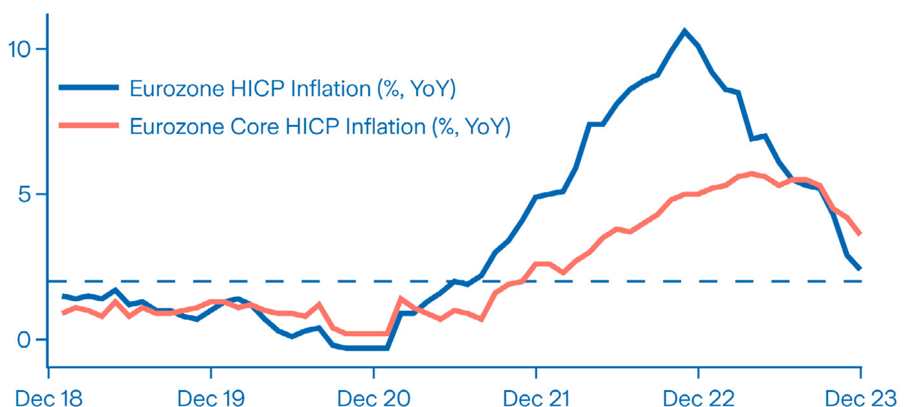
Sovereign spreads, mind the gap

We see the first half of the year as one of elevated danger for Eurozone sovereign spreads, before a longer-term supportive backdrop prevails by the year's end. Given our negative macroeconomic outlook, there are clear risks around debt sustainability concerns. A catalyst for market pressure would be ECB pushback on current market pricing for rate cuts and any acceleration of balance sheet reduction plans. We see this most likely occurring at the beginning of the year, when sticky inflation fears may resurface and the central bank re-emphasises its commitment to the 2% target. The reintroduction of the Stability and Growth Pact matters too, with more than half of Eurozone countries, including France, Italy and Spain, forecast to be criticised for excessively high 2024 deficits. Italy looks particularly vulnerable given a high starting debt load (around 140% of GDP), slowing nominal GDP growth and increasing interest expenses. In the long run, however, European solidarity in the face of a difficult geopolitical environment will likely lead to greater cooperation and solutions for debt sustainability that will calm market concerns. EU bond issuance is another example of Eurozone integration through crises, laying the groundwork for further fiscal cooperation.

High Yield credit is vulnerable with Investment Grade a better value

Credit spreads are likely to experience a material spread widening in H1 2024 followed by a recovery later in the year given the high risk of a US recession and tight credit conditions. Funding costs are likely to rise at a sharper pace for European companies given that corporate bond yields were extremely low before 2022 and hence the refinancing of old low-coupon debt will impact interest coverage adversely for many quarters. Further stresses on High Yield are likely to arise from the fact that the maturity wall for European High Yield is closer than it is for US High Yield while supply has been dismal and bank credit conditions remain tight. The European Investment Grade market is better priced, however, with wider spread levels, especially in Financials and comparison to US Investment Grade appears favourable as the latter is a lower credit quality market but trades at a tighter spread level. ABS spreads are expected to widen given the risk of an economic recession and the deterioration of underlying consumer credit fundamentals. The impending end of the ECB's asset-backed securities purchase programme (ABSPP) should also be a negative for the asset class. That said, given the lack of new issuance and the nature of senior tranches (short duration, AA rating and floating rate coupon), we think that spread widening will remain limited and that ABS should outperform other credit segments. Covered bond spreads are expected to move wider again in 2024 after underperforming in 2023, but fundamental deterioration should be limited and safe haven bids can emerge in the scenario of a recession.

Inflation is clearly moving back towards the 2% target



Source: Bloomberg, Eurostat

Equities—tough love

Eurozone equity markets will likely struggle through 2024, but we ultimately see a small positive return by the year's end. We expect corporate profitability metrics to diminish throughout 2024, with profit margins returning close to longer-term averages (~8%) from the elevated levels of >10% in 2023. Similarly, both earnings and sales growth estimates continue to look optimistic given the poorer fundamental backdrop. Nevertheless, Eurozone equities already trade at lower valuation multiples than peers, particularly the US, even when accounting for the disproportionately strong contribution of US tech companies. Additionally, global macro factors ought to benefit equity valuations more broadly, particularly into the second half of the year. These include the expectation of central bank easing, and not just from the ECB, promoting a revaluation from both a discount rate perspective and improved prospects of future growth. Any evidence of the unwinding of a long period of USD strength would likely aid equity valuations. On a relative basis within the region, we anticipate a reversion of markets that outperformed in 2023—and see the Italian and Spanish indices both underperforming the Euro Stoxx 600 Index. Both markets have disproportionately high bank exposure (just below 30%), where we expect lower returns from falling net interest margins while the macroeconomic deterioration impacts asset quality and loan growth.

Germany

Outlook

- The German economy to oscillate around stagnation through 2024
- Labour market weakness to develop further and dampen wage demands
- Progress on economic transition will be slow, hampered by fiscal controls

Implications

- Bund yields to decline, but already relatively low yields reduce capital gain upside
- German equities will be in the middle of the Eurozone pack with modest gains
- Political willingness for additional fiscal support remains in the longer-term

Risks

- Pessimism is high for both for economic consensus and markets, reducing price sensitivity to further bad news
- Labour market weakness is not a given while real wage growth could buoy consumption
- A deeper recession, too, remains a key risk

The doldrums

Barring a highly unlikely surge in Q4 GDP growth, the German economy will contract in real terms in 2023. We forecast stagnation in German GDP throughout 2024 and expect it to follow a similar trajectory to the Eurozone as a whole: a mild recession in the first quarters that gives way to a modest recovery towards year end as policy support increases. We see the inverse for inflation, with risks for higher numbers at the beginning of the year as energy tailwinds fade, before demand factors see a move to just above the ECB's target by year end. We expect the manufacturing malaise to continue with the falling stock of existing orders and flow of new orders suggesting further but more modest production declines in 2024. The picture around net exports is more nuanced as this measure did not detract from overall GDP growth in 2023 given the faster decline in imports than exports. We see net exports creating a more significant impact in 2024 as export competitiveness struggles. Looking more broadly at the expenditure side of the economy, we anticipate headwinds for household consumption, business investment and government expenditure. We see unemployment increasing throughout the year, although still positive real wage growth means stagnation rather than severe recession territory. The high rate environment should weigh on investment intentions and difficulties will not be confined to the much-discussed construction sector. Government expenditure, discussed further below, will likely be less supportive than in recent years. However, given the fall in government expenditure as emergency support faded in 2023, the impact on GDP for 2024 is unlikely to be significantly negative. Lastly, we note a glint of optimism in recent German survey data: both from the ifo and the ZEW surveys. While measures of the current German economic situation have been falling precipitously, the outlook for future activity is improving. We interpret this as increasing the probability of our base case of stagnation, while reducing the risk of a severe and worsening recession.

Rebuilding competitiveness

Ultimately, the German economy should successfully realign for a new era, but we see this process taking several years. In the meantime, the 2024 outlook remains challenging, with a variety of headwinds to overcome. Firstly, the good news is that the energy situation has moved from one of risks of acute emergency amid possible blackouts to a longer-term competitive disadvantage. German gas storage levels are above the long-term average, and although natural gas prices are multiples of the pre-2021 levels, prices are much lower than throughout 2022. While it is entirely possible that an exceptionally cold winter or new unforeseen shocks lead to further surges in prices, we see the environment necessitating a persistently higher level of energy expenditure for firms and households that will continue to change incentives and behaviours. We can clearly see the negative impacts in industrial production, and specifically in the 'energy-intensive' sub-index, which has contributed the majority of the real decline in industrial production figures. The five industries included in the energy-intensive measure account for around 77% of total industrial energy usage, but less than 20% of gross value add. This sub-index is likely to detract less from the overall measure as recent data show steadier production at lower levels, but we see continued reason for concern. On an ongoing basis, German industrial competitiveness continues to suffer from higher energy costs, increased unit labour costs from negotiated wage demands, and is also facing a likely decrease in planned government subsidies. Lastly, concerns have been raised by German businesses about the practical implication and burdens of well-intentioned EU directives. The Corporate Sustainability Reporting Directive (CSRD) came into effect at the beginning of 2023 and requires large and listed firms to report on sustainability according to detailed EU frameworks. Despite the EU's commitment to regulatory simplification, increasingly complex reporting requirements both increase administrative costs and represent significant room for improvement in streamlining regulation from Brussels.

Belabouring the point

The official federal statistics agency unemployment measure remains close to historic lows at 3%. However, we have already seen initial evidence of weakness from a variety of measures, and we expect this trend to continue throughout 2024. Another measure of unemployment, which complicates international comparisons through its treatment of part-time workers, stands just below 6%, having risen from lows of 5% in mid-2022. Registered unemployment has been increasing steadily throughout the year, a trend we see continuing. Outstanding job vacancies peaked in the middle of 2022 and are now back to pre-Covid levels. Newer data series, such as the 'Indeed' job posting indices, show both a decline in total and new job postings for Germany, which we expect to continue. Reported employment activity from the PMI data is firmly in contractionary territory as well. Although this has been driven by manufacturing firms, demand for employment is also falling in the larger service sector. Accompanying our expectation of a labour market slowdown is a decrease in wage growth. While exceptionally high wage growth was recorded in Germany in the first half of 2023, higher frequency indicators such as the HiringLab wage tracker are already showing a steady decline. While we anticipate the process to be gradual and consistent with small real wage increases, we nevertheless see wage growth falling back to recent

The current situation has rarely been worse, but future optimism is rising

Source: Bloomberg, ZEW

historical norms and levels consistent with the 2% inflation target. 2022 and 2023 saw significant labour union demands and strike action, primarily driven by a desire to recuperate real purchasing power. The above drivers should see negotiations between unions and employers become more balanced in the coming year.

Emergency brakes

A constitutional court ruling in November dealt a blow to the coalition government's ambitions and increased uncertainty around the fiscal outlook. We see the implications here as a net negative for the German outlook by increasing the hurdles to a necessary economic transition but see the immediate 2024 GDP impact as more muted than large headline numbers suggest. In order to deliver on various campaign promises, the eclectic ruling coalition repurposed authorised but unspent funding into vehicles for future expenditure. This was done to circumvent Germany's constitutional debt brake, where the structural deficit cannot exceed 0.35% of GDP other than in emergency circumstances. The court ruled that this retroactive reallocation in the 2021 supplementary budget was void. Although this decision clearly and immediately constraints government support, there are factors that soften the blow. Firstly, there may yet be legal ways to circumvent the debt brake given that a large political constituency sees an urgent need for government efforts to support transition and reform. We have already seen a decision by the government after the court ruling to declare an emergency for the 2023 budget, although the situation for future budgets is much less clear. Secondly, the direct impact for 2024 is likely to be limited. Although a headline EUR 770bn of funding is at risk, the anticipated future disbursal from these programs was much lower and over a multi-year period. The clearest casualty is the EUR 60bn Climate Transition Fund, where concern stems more from a slower economic transition rather than what was due to be a small direct stimulus to GDP growth.

The long-forgotten warnings on QE

We anticipate increased scrutiny over the operational implications of ECB policy and potential losses at the Bundesbank. This will likely 1) increase the hurdle for additional quantitative easing in the future and 2) create sharper domestic criticism of the ECB. Although there is good reason to believe excess reserves in the banking sector as a whole will remain at structurally higher levels than in the past, the current framework of reserve renumeration has a particularly strong impact on the German Bundesbank. An IMF paper from July 2023 ("Raising Rates with a Large Balance Sheet") highlighted this issue as being particularly acute in Germany, although the losses are temporary. Bonds bought at low yield levels are generating lower income than the current rate of interest paid out to the banking sector on reserves. Although neither the ECB nor the national central banks are locking in capital losses by selling bonds outright, a temporary income vs. expenditure mismatch may lead to uncomfortable considerations for national financial ministries across the Eurozone.

Equity markets, middle of the pack

We expect the German equity market to realise a small positive return this year and forecast that Germany will be a median performer among its Eurozone peers. In line with high positive correlations, our overall expectation for Eurozone equities follows for Germany: rising concerns in the first half of the year followed later by a recovery as policy support underpins valuations. Forward looking estimates for the DAX Index reflect both realised fundamental difficulties, but also anticipate a further squeeze on earnings and profitability. Although we do not disagree on the direction of those two metrics, the estimated falls in Germany look overly pessimistic relative to the broader region.

Further German bond strength, but plenty priced

We see German bond yields declining in 2024 but remaining significantly above pre-Covid levels. A number of rate cuts are already embedded into the yield curve for 2024 and further out, reducing upside potential. This is further exacerbated by the current relatively low yields on German bonds in a global context. The curve should re-steepen as the ECB delivers rate cuts. We see the best expression of this view in 10yr yield vs. the 30yr yield, where we expect the spread to increase further. This is firmly in an uptrend but remains below historic norms. With yields still higher than pre-Covid, and a higher hurdle for central bank activism through non-conventional policy, long-end bonds should cheapen to account for duration risk. The improving German fiscal outlook, helped from this perspective by the debt brake, is marginally supportive for bond yields, but we see risks of complacency here. The ECB's quantitative tightening program, which we expect to continue throughout 2024, will still require net new demand from the private sector and at relatively low yields.

Job vacancies are now below pre-pandemic levels

Source: Bloomberg, Destatis

Switzerland

Outlook

- The growth outlook remains subdued, but a recession should be avoided
- Inflation is likely to strengthen near term, but the underlying trend remains benign
- The SNB maintains a hawkish tilt, but no further rate hikes are expected

Implications

- Bond yields are set to remain rangebound amid a stable outlook
- The Swiss franc should remain in demand and supported by the SNB

Risks

- A deeper and more disorderly Eurozone crisis
- An unexpected and disruptive shift in SNB policy

Subdued but improving growth outlook
Economic activity has been weak this year, with GDP contraction in Q2 followed by a modest rebound in Q3. The manufacturing sector, which is estimated to have contracted by over 4% YoY in Q3, is suffering from sluggish external demand, amplified by an unfavourable inventory cycle. Both business and construction investment have stagnated, along with exports. As anticipated, private consumption has held up better, amid solid labour markets and healthy household finances. With headwinds persisting in H2, we anticipate that economic activity will have grown very modestly in Q4, leaving GDP up around 0.7% in 2023. Looking forward, activity is set to remain subdued into 2024, given a weak external backdrop and the lagged effects of policy tightening, but conditions should start to improve over time, particularly in manufacturing where the inventory cycle should become less of a drag. Given this profile, we expect the economy to expand at around 1% in 2024. While a modest improvement compared to 2023, this is still well below the longer-term average of 1.8%, which should allow spare capacity to start to build up and restrain wage and price pressures more broadly.

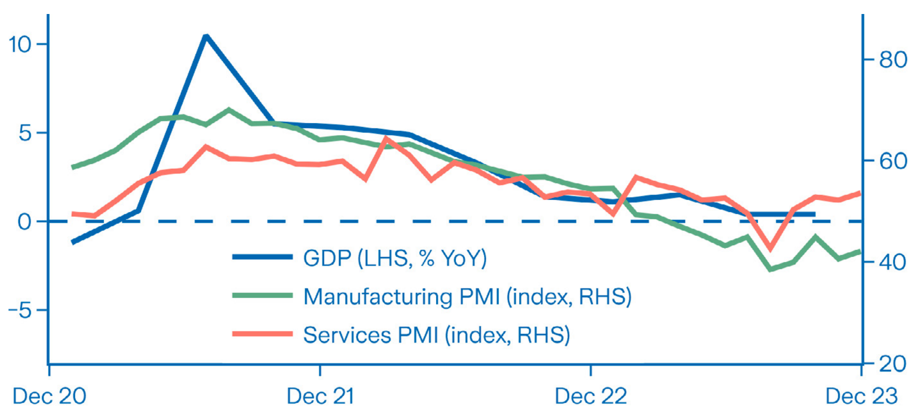
The economy remains resilient, and a deeper recession is not expected
While economic conditions will remain challenging, reflecting external headwinds, policy tightening and domestic bank issues, we do not anticipate a more severe drawdown in economic activity in 2024. Although interest rates have risen, financial conditions are favourable compared to other regions, with long-term interest rates fluctuating around 1%. Household purchasing power has held up well given relatively modest price pressures, and savings are high. The labour market is structurally tight, with a lack of workers in key sectors. Net migration has been notably strong over the past years and demographics are set to remain favourable, especially compared to many European peers. The housing market has also held up well, given tight supply and solid demand. While job growth should slow over the coming year, the deterioration is likely to be modest and comes from a high level. This brings resilience to the household sector, which we anticipate will support domestic spending going forward, helping to offset some of the weakness coming from abroad.

The economy also remains resilient more broadly, given the highly diversified industry structure, sticky and relatively price insensitive export demand, and a multitude of trading partners, which helps in a volatile and divergent economic environment. The fiscal situation is solid, with general government debt below 40% of GDP, less than half of the Eurozone average of 90%, and with the fiscal balance back in green after the Covid crisis. While we anticipate fiscal authorities will remain prudent, there is fiscal space to support the economy, should a more severe slowdown materialise.

Sporting events will distort headline GDP data
Switzerland is home to various international sports organisations that receive revenue from television and branding rights when major sporting events are held, boosting Swiss GDP. Since these sports events are not held every year it distorts annual growth rates and injects significant volatility into the GDP statistics, with a meaningful impact given the size of the Swiss economy. In 2024, the Olympics Games and the European Football Championship are expected to give an artificial boost to published GDP growth, estimated at around 0.3 percentage points.

Inflation is likely to rebound on rising rents, but underlying trends are benign
Inflation has fallen further, with both core and headline CPI below the 2% reference level. The decline in price pressures has primarily been driven by energy and imported components while domestically driven services inflation is still a tad higher. The strong currency has been a tailwind for falling inflation, both through its impact on import prices and by constraining pricing power among Swiss producers that compete in a global market. Disinflationary global goods prices have also helped to drive price pressures lower.

Weak growth, but a recession should be avoided



Source: Bloomberg

Looking forward, a number of CPI components will exert upward pressure on prices in 2024, and we expect CPI inflation to rebound early on, before settling down at a lower level later in the year. Rent inflation, which has a share of almost 20% in the CPI index, will rise as a result of an increase in the regulated reference rate for rents, alongside scheduled electricity price and VAT hikes in early 2024. While the impact of rising rents on CPI is uncertain, underlying inflation trends are modest. Wage growth, which is a key driver of price pressures in the services sector, has been flat at 1.8% YoY in the first three quarters of the year, which is insufficient to drive inflation materially higher. The Swiss franc is also expected to remain in demand, with currency strength continuing to constrain price pressures.

The SNB maintains a hawkish tilt, but further rate hikes are not expected

The Swiss National Bank has hiked rates by a total of 250bps in this hiking cycle, taking the policy rate to 1.75%, the highest level since 2008. The pace of rate hikes has continued to lag that of most other regions, but the SNB also relies on FX interventions to strengthen the currency, with the broad nominal exchange rate up by almost 5% YTD. While the central bank maintained a hawkish stance and continued to hike rates in March and June, despite bank stresses, they refrained from a further hike in September, while also revising down the long-term inflation forecast to below 2%. This was a dovish shift and, unless inflation reaccelerates more strongly than anticipated, signals that the SNB is likely to be done tightening in this cycle. We have pencilled in one rate cut towards the end of 2024, though the outlook remains highly uncertain and dependent on ECB policy. With economic activity set to stay relatively resilient, and given the limited rate hiking cycle, prospects for a more material rate cutting cycle beyond 2024 are limited, unless growth were to deteriorate more sharply. This implies a slightly higher rate path than what is currently priced in markets, but a peak rate that is still well below that of most other regions over coming years.

The Swiss franc to remain in demand

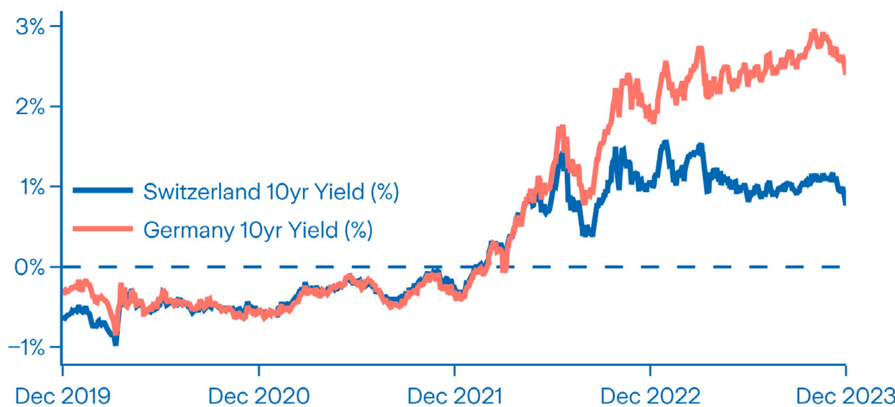
The SNB has been active in foreign currency markets and continues to rely on currency appreciation as a tool to limit inflation. At the September meeting, the SNB reiterated its willingness to intervene in FX markets going forward. We anticipate this will continue to underpin Swiss franc strength. Underlying FX fundamentals are also solid, with a current account at close to 10% and a steadily rising trade balance – up by over 40% compared to the pre-Covid level (in USD). Safe-haven demand for the Swiss franc is also likely to remain a tailwind, given a fraught geopolitical backdrop.

Swiss government bond yields expected to remain stable

As anticipated, Swiss government bond yields have been trading within a relatively narrow range in 2023, with relative outperformance compared to other bond markets reflecting the more benign inflation backdrop, lower policy rates, and a strong fiscal position. Looking forward, we anticipate that yields will remain stable given limited prospects for rate cuts, while further rate hikes are not expected.

As a result of policy divergence, spreads between German Bund and Swiss Confederation bond yields, which had become increasingly compressed over the past decade as the SNB approached the lower bound on interest rates, have recently surged to multi-decade highs. They now appear stretched, and we would expect them to narrow going forward.

Swiss government bond yields decouple on inflation and policy divergence



Source: Bloomberg

Japan and South Korea

Outlook

- Will Japan be able to initiate and maintain a meaningful uptrend in wages and salaries?
- Consumption is likely to get a boost from rising disposable income
- South Korea's economy should benefit from a rebound in tech exports and policy stimuli

Implications

- Japan's equity market should continue to shine amid a favourable earnings outlook
- Japanese credit to stay resilient but upside is limited
- Japan's government bond market is expected to be rangebound while the yen should strengthen

Risks

- A failure of our expected positive wage-inflation cycle, leading to economic stagnation
- A more severe recession in the US and Europe or yen appreciation could hamper exports
- Tensions with China and North Korea escalate

Wages and inflation will be in focus
For decades, Japan has been suffering from deflation. Policy makers are now eager to manage a turnaround. Politicians and the Bank of Japan (BoJ) hope to initiate and then maintain a virtuous cycle between wage increases and inflation. The former has been evident in the last two years, when nominal wage growth moved to a thirty-year high, though real wages continued to contract amid higher inflation. As we expect both headline CPI and core-core CPI (excl. food and energy) to fall in 2024, there is a high probability that real wage contraction will come to an end. So far, the missing link, the willingness of companies to raise prices not only due to cost-push inflation (like higher oil prices or yen depreciation), but also due to wage increases, should become apparent once there is a public consensus or some industry leaders move ahead. Were this to happen, a virtuous wage-inflation-wage spiral could arise, which would be welcome as long as it does not accelerate significantly above the BoJ inflation target. Japan's economic outlook for 2024 depends on how wages and inflation are developing and how monetary and fiscal policy react.

Economists as well as the BoJ are monitoring the outcome of the next 'Shunto' round of wage negotiations between Rengo, Japan's major labour organisation, and Keidanren, the employer association. The Shunto outcome should also be relevant for SMEs, though small companies tend to struggle to follow major firms amid their challenging business environments. Some indications hint at a continuation of solid wage hikes in 2024, as Rengo has already announced that it is targeting wage hikes of '5% and more', while Rengo's subsidiary, covering specific industries like retail, chemicals and textiles, is even requesting a 6% hike. Adjusting for sample changes, wage increases are expected to be higher than the 2.2% achieved last year.

Consumption should get a boost from higher disposable income
Considering that real wages are no longer expected to be negative, as in 2023, consumption should continue to be brisk, even without the positive impact of the reopening boom that pushed up services consumption following the ebbing of Covid. In addition, disposable income is expected to benefit from the income tax refund worth JPY 5tn (1% of GDP), which is part of the economic stimulus package that was recently announced and is scheduled to be disbursed in summer 2024. JPY 40,000 per person will be disbursed as a tax rebate, while JPY 70,000 will be paid separately to households who are not paying resident taxes. We assume that about one third of the payments will be spent, while the rest will be saved. We anticipate that this fiscal measure should help to spur overall consumption in both Q2 and Q3 of calendar year 2024 before levelling off.

Inbound consumption by foreign tourists is already close to pre-Covid levels, as tourists, on a per capita basis, are spending about one third more due to the substantially weaker yen. However, the number of tourists is still 15% below the 2019 level. We expect this gap to close in 2024 as more Chinese tourists are likely to travel to Japan. In 2023, administrative hurdles in China as well as limited flight capacities hindered many Chinese tourists from visiting Japan, so that only about one-third of the pre-Covid number of Chinese tourists was reached. Visitors from China, Korea and Taiwan are highly likely to make up the majority of foreign visitors to Japan in 2024.

Investment growth driven by structural requirements
We stick to our belief that Japan's capex outlook is structurally positive, based on the fact that labour saving automation, digitalisation and environment friendly production methods will continue to be employed. However, cyclical swings will also play a role. We believe the current slowdown may continue into the first half of 2024, incorporating our global outlook and leading indicators like machinery orders. However, fixed asset investments should gain speed again in the second half of the year. A potential export volume recovery depends on global economic conditions. We believe a somewhat lacklustre outlook for the first half of the year will be followed by a more

Welcome inflation!

Source: Ministry of Internal Affairs and Communication, Bloomberg

dynamic development in the second half of the year once the current inventory overhang subsides. In 2023, auto production gained steam following the Covid-related supply-chain disruptions. Speeding up the launching of more e-vehicle models should help.

The Bank of Japan will be in focus throughout the year

The major investor focus in 2024 will be on the Bank of Japan. Will the BoJ exit Yield Curve Control (YCC) and Negative Interest Rate Policy (NIRP), and if so, when? Brokers have a wide spectrum of forecast periods, that even last into 2025. We take into consideration that BoJ Governor Ueda tends to have a very cautious attitude, while it seems that the BoJ Board including Ueda's Deputy Governor tend to have a desire to return to 'normal' monetary conditions rather sooner than later. Our belief is that NIRP will be abolished in April, at the first meeting in the new fiscal year, while it may take longer to exit YCC de facto, probably some months later in October 2024. We suspect that this will help to drive a recovery in the economy.

Meanwhile, we expect Japanese bonds to soften somewhat, as global investors may test the upper reference point of JGB yields at 1% again. However, domestic investors are expected to step in as strong buyers, limiting any breakdown in JGBs. We expect the JGB yield to hover between 0.6 % and 1%.

In terms of fiscal policy, the recently announced package will amount to JPY 17-22tn, which is bigger than expected. However, it actually translates into a fiscal drag, compared to the JPY 31tn two supplementary budgets last year. The package will be financed by JPY 13bn of fresh funds and some leftover from prior fundraising. The new fundraising pales to the JPY 25tn of funds raised in the prior year.

Japanese credit to outperform global credit in H1 2024 but lose the shine later

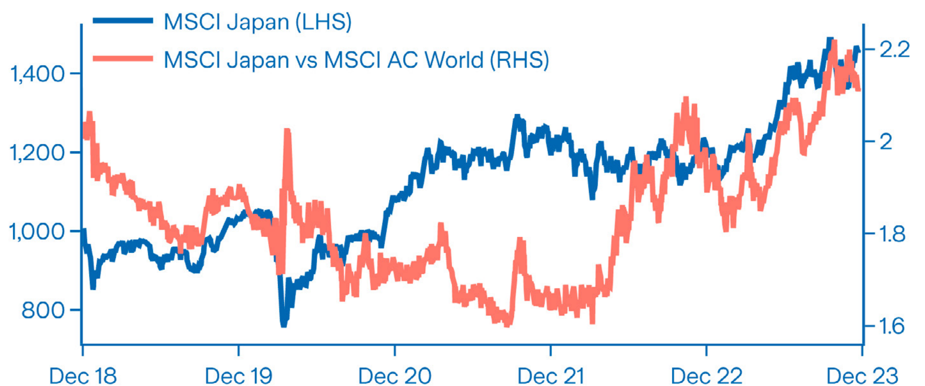
We expect the Japanese credit market to hold in better than global credit markets, particularly in H1 2024. The more stable yield environment along with spreads that are relatively cheap to their own history is likely to keep a lid on any spread widening from a potential contagion of global credit weakness that we expect in the beginning of the year. In addition, a more stable yield environment along with a strengthening trend in the yen is also likely to support flows into the asset class. The default outlook is likely to be quite benign for Japanese credit. However, all in all, given the stronger credit quality of the Japanese market, upside is rather limited and relative outperformance is likely to ebb later on in the year as global credit markets recover, led by the US.

Constructive outlook for Japan's equity market

We maintain our constructive view on Japanese equities. We believe our benign growth and inflation outlook underpins a favourable corporate earnings outlook, while reform measures will continue to be a topic. The latter primarily refers to corporate governance reform urged by the Tokyo Stock Exchange (TSE) as well as further reduction in cross-shareholdings. Both drove a rally in spring 2023 and should underpin further upside potential in 2024. More companies will bend to peer pressure to follow those who have already proven that such action brings benefits to companies and their shareholders.

We also believe that the relaunch of the Nippon Individual Savings Account (NISA) will be successful. NISA is a tax incentive system for individual investors, which had been first launched in 2014, and includes tax-free periods of 5 or 20 years. We believe the new NISA scheme will be an important driver to increase the still low share of Japanese individuals who own equities. Those who have benefitted significantly by investing in overseas markets before may be tempted to take profits and instead invest in local equities, which should give a boost to Japanese equities. We see the main risk in our expected yen-appreciation scenario in line with the narrowing yield gap between the US and Japan. A stronger yen tends to have an adverse effect on Japanese equities.

MSCI Japan, and relative to global equities



Source: MSCI, Bloomberg

South Korea's economy

Our 2024 outlook for South Korea's economy is relatively benign. We expect GDP growth to pick up to about 2% from the projected 1.3% in 2023. Two factors are playing a role. Firstly, we believe that the rather restrictive monetary and fiscal policy will ease. The Bank of Korea was very early in the hiking cycle, which should allow for an early cut in the policy rate already in Q1. We note that in the latest Monetary Policy meeting, one member already opted for a rate cut. Tight fiscal policy should also have room to loosen, not least as parliamentary elections are due in April. Last year, a path of medium-term fiscal prudence has been followed, which should prevail. With that in mind, we expect fiscal policy to be mildly expansionary. Secondly, the tech cycle has already turned to the upside, which is boosting exports. South Korea is a beneficiary of strong demand for chips needed for Generative Artificial Intelligence technology, as it is a prime producer of high bandwidth memory.

North Korean threats prevail

We earmarked the geopolitical risks from North Korea in last year's outlook. Our basic stance has not changed, as we see even increasing risks for South Korea and Japan. North Korea has again tested various ballistic missiles fired towards the Japan Sea, and its significant boost to military cooperation with Russia is another reason for concern. We also note, however, that cooperation between Japan and South Korea has significantly improved under the new leadership in both countries.

Mainland China and Taiwan

Outlook

- While China's reopening boost is ebbing, policy intervention should fill the gap
- Targeted infrastructure investment is expected to support growth
- Property market activity will remain a major drag, though less so than in 2023

Implications

- Monetary policy is expected to remain loose while the fiscal policy boost should gain speed
- Chinese credit is vulnerable to property sector woes and we prefer stocks
- Chinese equity performance is expected to improve on solid earnings growth and valuation support

Risks

- Dissatisfaction among the young generation increases amid high youth unemployment
- Tensions with the US, Japan, Australia or India increase
- Policies to stabilise and rejuvenate the property sector are insufficient

The dynamic Year of the Dragon

2023, the year of the Rabbit in the Chinese zodiac, was dominated by the reopening boom and strong services consumption, followed by further turbulence resulting from the property downturn and a series of important policy meetings, including the National People's Congress (NPC) that strengthened the power of President Xi. 2024 will be the year of the Dragon, which tends to be the most favoured within the twelve zodiac animals by the Chinese.

Consensus estimates for last year's economic growth experienced a rollercoaster ride as the reopening boom during spring was extrapolated, followed by a wave of downward revisions due to the intensifying problems in the property market. Then optimism increased somewhat into autumn. Our growth estimate for 2023 has been relatively stable and stands at 5.2%, while we expect growth in 2024 to be around 5%. We would not be surprised to see the official growth target set during the Central Economic Work Conference in December 2023 and officially announced during the National People's Congress in spring 2024 to be around 5%. As the reopening effects from Covid continue to ebb, we think this will be partially offset by a significant direct and indirect positive growth impact from policy stimulus.

China's central government has learned its lesson from the past when public stimulus was excessive and unproductive. The 'new black' is targeted stimulus, particularly in areas like protection of the environment, modern production facilities and technological progress. Property investment will be steered into urban village renovation and public housing. Amid their strained finances, we do not expect any notable impetus from local governments as they have previously relied on about a third of their income coming from land sales, a source that has now run dry.

Instead of a big boost, we expect the government to continue its approach of a series of targeted stimulus measures throughout 2024. For example, China's NPC Standing Committee authorised the Ministry of Finance to issue RMB 1tn in government bonds, scrapping the 3% limit and increasing the budget to 3.8% of GDP. Local governments will thus be able to expand infrastructure investments. The committee also approved the frontloading of the 2024 special local government bond quota. We applaud these stimulus measures, though we note that local governments have already lost RMB 3tn in land sale revenue due to the property crisis. Referring to another action point, we note that the PBoC may fund at least RMB 1tn in major infrastructure and property projects via policy banks. This 'QE' injection may indeed help to revitalise the related sectors. While urban village renovation projects might benefit first, we believe tackling the lagging delivery of pre-sold homes should be prioritised. We think that more targeted measures will be taken during 2024 in order to support the economy.

Consumption outlook remains constructive

Private consumption surged in 2023 following three years of paltry consumption during China's zero-Covid policies. Services, particularly transportation and entertainment, were the core growth drivers. For 2024, we expect the growth rate of consumption to shrink, though our outlook remains constructive. We do not believe that the government will launch broad measures to spur consumption, as it had refrained from doing so even during the Covid years, in contrast to the US and Europe. Even though we expect excess savings that were accumulated during the pandemic years will slowly be released, consumer confidence will not increase materially as the property crisis is expected to prevail. It is likely that overseas trips will accelerate from a somewhat paltry speed in 2023, partly as administrative hurdles to get passports and visas will be reduced, but it is unlikely to move back to pre-Covid levels, one reason being that it is no longer necessary to travel overseas to buy Western luxury goods as they are now available domestically at reasonable prices. Consumer categories like outdoor entertainment and fitness should continue to boom.

Solid manufacturing investment, targeted infrastructure capex and a reduced drag from property investment should benefit capex growth

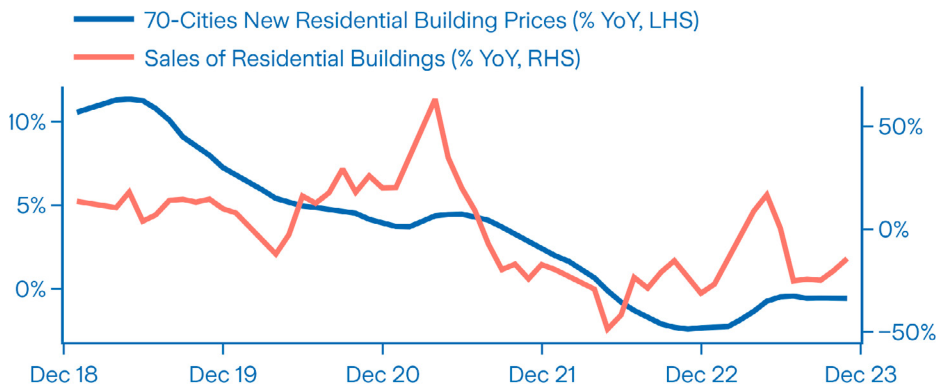
Infrastructure investment is one of the key government targets to stimulate the economy. As mentioned before, we do not believe that public investment will be channelled into new highways in the middle of nowhere or another ghost town, but rather into green investments, EV-charging stations, 5G, and new production facilities, even though some traditional infrastructure projects are also likely to benefit. As industrial profits have turned positive and exports are expected to recover, manufacturing investment should grow at a quicker pace than last year.

Meanwhile, property investments are likely to remain in the doldrums, even though they may contract somewhat less than in 2023, boosted by fiscal support, including public housing and urban village renovation. Overall, we have pencilled in a growth rate of around 5%, in line with our projected GDP growth rate. Exports may suffer in the first half of 2024 amid weak US activity but are expected to recover in the second half of the year. Export prices should stabilise, following a drop in 2023.

From deflationary territory to soft inflation

Following a rather severe drop in H1 2023 due to falling energy and durable goods prices, consumer prices started to stabilise in the second half of the year. For 2024 we expect consumer inflation to climb again but should not rise to more than 2% YoY. As always in China, inflation is dependent

China's property sector remains in the doldrums



Source: Bloomberg

on the pork price cycle, which is expected to put some upward pressure on inflation. Core inflation is expected to come in slightly above 1%. Producer prices and the GDP deflator are expected to move from currently deflationary to slightly inflationary territory on rising raw material prices.

Chinese credit to remain hostage to property sector doldrums and global credit vulnerabilities

The property sector in Chinese credit has experienced severe challenges during the last two years and this is likely to continue in 2024. With annualised default rates running, and expected to continue running, at around 30% or more in the High Yield property sector, risks abound, particularly from potential contagion and the vulnerability of the financial sector and local government credit. In such an environment, credit spreads in both Investment Grade and High Yield appear unappealing, with added vulnerability from global credit weakness during H1 2024 also adding to the risks. Hence, in line with our view on global credit, on a relative basis we would prefer Chinese stocks to Chinese credit markets.

Chinese equities are expected to crawl out of the doldrums

We distance ourselves from doomsayers and have a rather constructive view towards Chinese equities. Our return forecast of slightly more than 10% for the MSCI China index mainly incorporates a favourable earnings outlook, as earnings momentum has already turned to the upside, lower interest rates, plus a valuation bonus from a very low base. Foreign investors are expected to turn less pessimistic towards Chinese equities. Middle East investors have already done so, and we expect at least some Western investors to follow. We also expect authorities to continue supporting the market, as they have done in the second half of 2023. Furthermore, property related write-offs are likely to diminish following two bad years.

Hong Kong's slow recovery is expected to continue

Hong Kong suffered from a significant downturn following civil unrest and Covid but is now in recovery mode. GDP contracted six quarters in a row in the second half of 2019 and the year 2020 and, following a recovery, again for four quarters in a row in 2022. We expect GDP to grow more than 3% in 2023 and at a somewhat slower rate in 2024, negatively impacted by weaker US activity in H1. Amid the linkage of the HKD to the USD, borrowing costs have surged to the highest level in 15 years. We expect the residential housing price drop experienced in 2023 to accelerate in H1 before stabilising later in 2024. On a positive note, we appreciate the significant policy support as expressed in the latest policy address by Chief Executive John Lee. A stamp duty reduction for securities trading and public housing projects should help to stabilise related sectors. We also note unexpected success in policies to attract new talent, which made up for all population emigration losses since 2020. Finally, Hong Kong should benefit from the Greater Bay Area Development Strategy, which consists of nine cities in the Guangdong Province, including Guangzhou and Shenzhen, plus the Special Administrative Regions of Hong Kong and Macau, with a total population of more than 70mn.

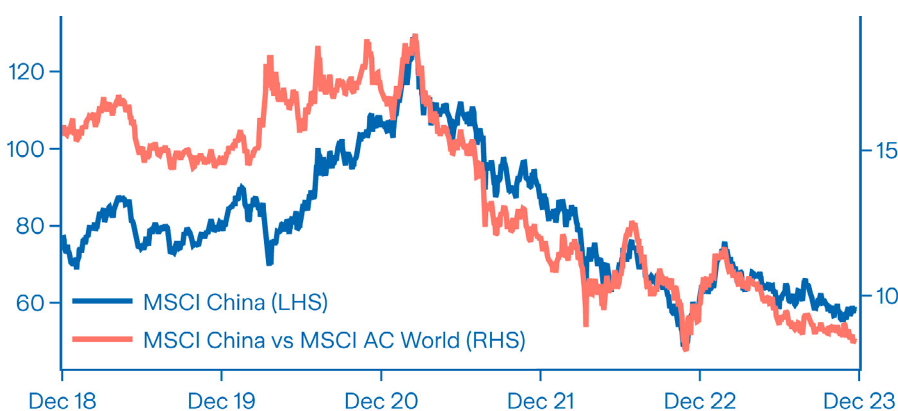
Taiwan should benefit from the upswing in the tech cycle and expansionary fiscal and monetary policy

Taiwan's economy started to recover in the second half of 2023, following a contraction in the first half. The recovery of the global tech cycle has benefitted Taiwan. We believe growth momentum will accelerate in 2024. Taiwan is a major hub for Generative Artificial Intelligence technology and one of the leading providers of semiconductors, which should benefit from the recovery in global chip demand. Domestic consumption is the second driver of the economic recovery, as cash handouts by the government have helped to spur consumption.

Fiscal expenditure is likely to remain high during 2024. As Taiwan is far from reaching its debt ceiling of around 40% versus its three-year-average GDP, we believe there is even more upside for fiscal policy if required. Meanwhile, Taiwan's central bank, the CBC, has kept its policy rate steady since March 2023. However, there is enough scope to cut if a US recession were to develop. We believe the CBC is likely to cut in steps of 12.5bps.

Political observers will need to watch the presidential election on January 13. Currently, the candidate from the ruling Democratic Progressive Party, DPP, is leading in the polls, followed by the candidates from the Kuomintang, KMT, and Taiwan's People's Party, TPP. An administered alliance between the KMT and TPP failed. A fourth candidate withdrew from the race shortly before the deadline. The DPP is challenging the One-China policy, while the KMT favours close contact to Mainland China.

MSCI China, and relative to global equities



Source: MSCI, Bloomberg

ASEAN and India

Outlook

- Growth is likely to improve but will remain below trend
- Inflation is expected to remain modest despite some upward pressure on food prices
- Policy rate cuts are anticipated in response to US monetary easing

Implications

- Equity performance is likely to be weak in H1 with a marked recovery anticipated in H2
- Bond yields should come down, driven by softer inflation and potential US rate cuts
- Depreciation pressure on local currencies will ease given peak US policy rates

Risks

- A resurgence of inflation keeps ASEAN central banks on a hawkish path
- The recovery in global trade fails to materialise, prolonging weak growth
- Increased risk-off sentiment leads to more fund outflows and puts pressure on currencies

Growth likely to improve amid a rebound of exports and resilient domestic demand
Growth is expected to improve modestly in ASEAN in 2024, although still below trend, driven by fading trade headwinds and resilient private spending. Signs of a gradual recovery in global trade are emerging, as indicated by the recent uptick in exports from Taiwan and Korea, bellwethers of global trade. Domestic demand across the region is expected to remain decent, supported by the favourable dynamics of easing inflation and potential rate cuts in the second half of the year. The major challenge to growth is fiscal consolidation in countries with high fiscal deficits from the pandemic, such as Malaysia and the Philippines. In contrast, India's growth momentum is likely to stay robust, driven by strong pre-election spending, solid IT and professional services exports, and robust infrastructure investment.

Despite upside risks on food prices, inflation pressure should remain modest
Inflation across ASEAN and India has consistently declined. The average inflation rate in ASEAN-6 (Malaysia, Indonesia, Singapore, Thailand, the Philippines and Vietnam) is expected to fall to 3.6% in 2023, while in India, headline CPI should decline from 6.7% in 2022 to a projected 5.5% in 2023. The disinflation trend is driven by easing global energy prices coupled with slower growth.

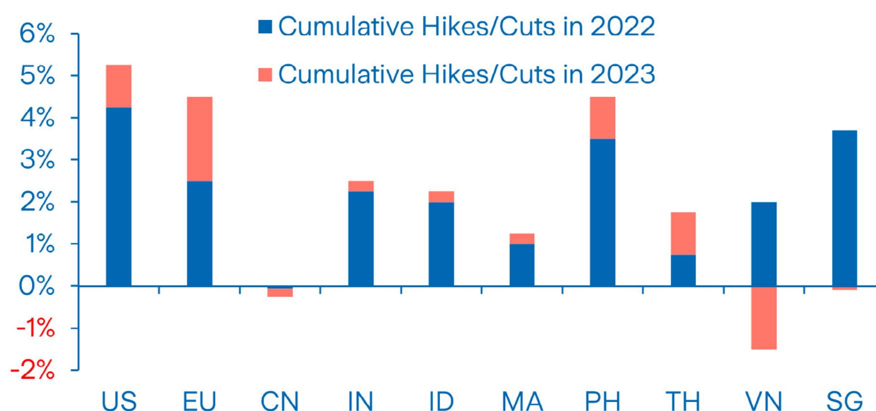
As we move into 2024, rising food prices, stemming from the negative impact of El Niño on the harvest season and food supply, may result in a spike in headline CPI. Pressure on food prices has recently been evident in India and the Philippines with global rice prices having surged by 17% since July 2023, following India's ban on rice exports. Yet we expect the spike in food prices to be transitory. Another factor that could drive inflation higher is the reduction in subsidies across different countries, and most pronounced in Malaysia. Yet risks of a persistent increase in inflation remain contained, considering below-trend growth and the relatively balanced supply and demand dynamics in ASEAN.

Central banks' next moves will depend on the direction of US rates
Despite weak growth coupled with a disinflationary trend, regional central banks, except for the State Bank of Vietnam (SBV), have refrained from cutting rates. Rising US Treasury yields resulting in a stronger USD have put significant pressure on regional currencies. The Malaysian Ringgit (MYR), for instance, has depreciated by around 6% year-to-date. Although current FX reserves remain sufficient, they have notably decreased as central banks have taken measures to defend their currencies. Recently, central banks in Indonesia, Thailand, and the Philippines have resumed tightening their monetary policy, partly to stabilise exchange rates.

For 2024, expected slower global growth may sustain a risk-off sentiment, keeping the USD strong. However, the anticipated peak in US policy rates should keep rate differentials stable, thus easing some currency pressure. Most central banks are expected to modestly cut their policy rates, by between 25 and 100bps, probably towards H2, should the Federal Reserve embark on its easing cycle. Exceptions include the State Bank of Vietnam (SBV) and Bank Negara Malaysia (BNM). The SBV has already cut rates by 150bps in 2023 and is expected to stay put in 2024 while BNM, which faces higher inflationary pressure following the removal of fuel and food subsidies, should refrain from cutting rates throughout next year.

Fiscal policy: different pathways back to pre-COVID normalcy
Fiscal deficits and public debt in ASEAN surged during the pandemic due to extraordinary support measures. To ensure fiscal sustainability and credibility, fiscal consolidation is expected in order to bring budget deficits back to pre-pandemic levels. However, the path towards fiscal consolidation remains challenging, particularly for some countries where governments continue to provide significant subsidies to alleviate inflationary pressures on households. Notably, Malaysia and Thailand are dedicating about 2.8-2.9% of their GDP to subsidies and providing cash handouts. In terms of deficits, Malaysia and the Philippines have the highest levels in

Weaker inflation led to fewer rate cuts by most central banks compared to the Fed



Source: Bloomberg

ASEAN, standing at 5.5% and 6.2% of GDP respectively, while Singapore and Indonesia have already returned to pre-pandemic levels. Moving forward, fiscal policy will depend on the growth potential and available fiscal space in each country.

Indonesia and Singapore are in good shape regarding fiscal availability while Vietnam will be able to sustain high budget deficits given its high growth potential. In contrast, Thailand faces the greatest fiscal constraints due to high deficits coupled with low trend growth. In 2024, major consolidation efforts in Malaysia and the Philippines are expected.

Malaysia: fiscal policy in focus

Malaysia's fiscal deficit is the second highest in ASEAN, and its public debt of around 67% of GDP is the largest in the region. Over the next three to five years, Malaysia plans to embark on fiscal consolidation, targeting a fiscal deficit of 3% and public debt of below 60%. The recent government budget has set a target of a 4.3% fiscal deficit in 2024, with projections showing a 0.8% YoY decrease in spending and a 1.5% increase in revenue through tax hikes. A significant portion of the budget cuts will relate to food and fuel subsidies.

Fiscal tightening is expected to have a negative impact on growth over the near and medium term. However, improving exports and resilient domestic demand are likely to offset fiscal headwinds. We expect Malaysia's GDP growth to be between 4.3-4.5% in 2024, remaining below trend growth but slightly improving compared to 2023. Regarding inflation, the reduction of subsidies and tax increases is likely to lift headline inflation, prompting BNM to hold its policy rate steady in 2023, partly to maintain currency stability. We expect inflation to hover around 3% for 2024.

Indonesia: the election year

Despite the global slowdown, Indonesia's growth remains resilient, supported by strong domestic demand on the back of robust pre-election spending and infrastructure investment. The presidential election, set for February 14, sees Prabowo Subianto and Ganjar Pranowo as frontrunners, though neither has a clear majority. While the elections may bring some policy uncertainty, we expect policy continuity in the medium term as both leading candidates have confirmed their intention to maintain Jokowi's focus on infrastructure, policy reforms, and developing the nickel industry.

Indonesia's GDP growth in 2024 is expected to stabilise at around 5%, driven by election spending and slightly relaxed fiscal policies. Inflation is expected to remain within Bank Indonesia's target range, with the potential for 100bps of cumulative rate cuts, which would lower the policy rate from 6% to 5% by the end of 2024. However, these rate cuts will heavily depend on US policy and currency trends given the IDR's high sensitivity to USD fluctuations.

India: a positive growth story but medium-term challenges remain

In a world of scarce growth India stands out with 6.5% GDP growth estimated for 2023, while having overtaken China as the world's most populous nation. The Indian government is actively enhancing relations with the US, while its IT and professional service industry is thriving amid global tech transformations.

Looking ahead to 2024, India's growth is expected to remain above 6%, fuelled by pre-election spending and strong infrastructure investment. The general election could see Prime Minister Modi's party retaining power, ensuring policy continuity. Despite its high growth potential, India faces several medium-term challenges including underdeveloped infrastructure and high poverty rate. Additionally, a high fiscal deficit, along with public debt more than 80% of GDP—one of the highest among emerging markets—also risks crowding out investment given that 40-50% of tax revenue is currently used to service debt. Therefore, fiscal consolidation is essential to reduce public debt over time.

In terms of inflation, there is upward pressure on food prices due to weather adversity and uncertainty around global oil prices. However, inflation risks are expected to remain modest, and the central bank may implement mild rate cuts towards the end of 2024, contingent on the trajectory of inflation and currency stability.

Equity: treading water

Global risk aversion and slower domestic growth coupled with weak corporate earnings have adversely affected ASEAN equity, with the MSCI ASEAN Index posting year-to-date losses. Weak sentiment has driven consistent net outflows from equity over the last quarter. That said, current valuations appear attractive, with P/E ratios trading below their 5-year average.

For 2024, US interest rate uncertainties and the strong USD will continue to weigh on the regional equity performance early in the year. However, with potential Fed rate cuts prompting ASEAN central banks to ease monetary policies, the market outlook should improve notably in H2. Furthermore, attractive valuations and light market positioning will also underpin the recovery.

Both Vietnam and Indonesia's equities are looking attractive. Corporates in these countries are benefiting from strong structural growth potential. Vietnam's economy is likely to gain momentum in 2024, while Indonesia's significant infrastructure projects, such as the construction of a new capital city and its role in the EV supply chain, offer substantial growth opportunities.

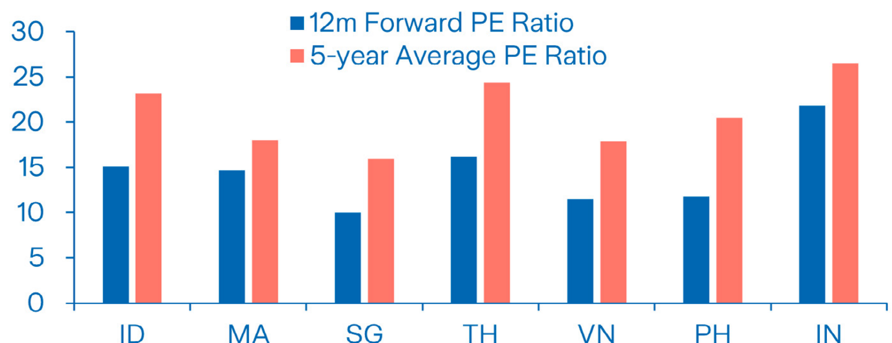
In India, the outlook for equity remains positive as the market appears to be in a bullish phase given the country's rapid growth, with corporate earnings showing solid trends. While Indian equities are among the most expensive in Asia, valuations look less stretched, with P/E currently trading below their 5-year averages.

Bonds to benefit from softer inflation and potential US rate cuts

As central banks have raised their policy rates, bond yields have risen across the board. Vietnam is the exception with lower bond yields amid central bank rate cuts. Despite a general rise in yields, spreads between ASEAN bonds and US Treasuries have compressed, and risk premia priced in CDS spreads have also fallen. Bond issuance has been relatively weak while domestic demand for government bonds from local institutions remains supportive.

The outlook for ASEAN local currency sovereign bonds in 2024 appears positive, shaped by three factors: the US Treasury yield trajectory, inflation and macroeconomic prospects, and risk premia. US Treasury yields are expected to decline in response to potential US rate cuts, which would allow regional central banks to reduce their policy rates, subsequently lowering local yields. Rate cuts, coupled with the prospect of an economic recovery, are likely to lead to a steepening of the yield curve towards the year's end. From a macro perspective, ASEAN's economic fundamentals are expected to be healthy, characterised by anticipated lower inflation and resilient growth compared to developed markets. Despite some countries still running high fiscal deficits, these healthy fundamentals suggest that a major repricing of risk premia is unlikely.

Weak growth may pressure equities, but valuations are becoming more attractive



Refer to major market indices in each country, ID=JCI, MA=KLCI, SG = STI, TH=SET, VN=VNINDEX, PH=PCOMP, IN=NIFTY

Source: Bloomberg

Australia

Outlook

- Growth is expected to slow further in 2024, but a full-blown recession remains unlikely
- Inflation will continue to fall, approaching the RBA's target range by the year's end
- Interest rates are expected to remain elevated in H1 2024, with potential rate cuts in H2

Implications

- Bond yields will continue to decline, driven by weaker growth and pending rate cuts
- Equity markets are vulnerable to drawdown, reflecting investor concerns about slower growth
- The AUD is expected to be weak, with a potential recovery towards the year's end

Risks

- Inflation accelerates, resulting in further monetary policy tightening
- Interest rate pressure triggers widespread forced sales in the housing market
- Outright recession leads to significant job and income losses for households

Weaker growth but a recession remains unlikely
2023 has presented significant challenges for the Australian economy, characterised by the most aggressive interest rate hikes in recent decades. The consumer sector, in particular, has felt the brunt of the rate shock given that Australian households are highly indebted and have their wealth closely tied to the housing market, a notably rate-sensitive sector. Moving into 2024, we anticipate a continuation of the slowdown, with growth expected to be below trend. However, the likelihood of a full-blown recession remains unlikely.

Consumption growth should stay subdued but will not plummet
Consumption growth has significantly weakened, largely due to the double whammy of a substantial rise in mortgage payments and increased living costs. However, consumers appear to be maintaining their spending levels rather than drastically scaling them back, especially in services and restaurants. This is indicated by retail sales data and household spending indicators, which have fared better than expected in Q3 2023.

Consumption resilience is expected to persist into 2024 as households continue to leverage their pandemic-era savings to smooth spending. The robust labour market, reinforced by recent wage hikes in both public and private sectors, is ensuring steady household incomes, underpinning continued spending. Furthermore, Australia's net migration inflows have surged. In the 12 months to March 2023, net migration reached 563k, equivalent to around 2.2% growth in population, significantly above the 10-year average of 1.4%. With net migration projected to stay strong for the next two to three years before normalising, this trend is likely to boost domestic demand in both the near and medium term.

A positive outlook for investment
Business investment is experiencing a strong rebound after a prolonged downturn that began before the pandemic. This resurgence is mainly fuelled by robust capital spending in the non-mining sector, notably on machinery and equipment as well as in construction. Despite higher labour and input costs straining corporate margins, business investment intentions for the next 12 months remain robust, as indicated by the latest Capex intention surveys. The current increase in capital expenditures reflects a catch-up in investments that were postponed due to the pandemic, coupled with the need to address current tight capacity utilisation. In sectors such as construction, supply shortages are evident, marked by low vacancy rates and elevated rents. We think this trend will continue into 2024. Over the medium term, robust population growth is expected to further stimulate investment, catering to the growing demand and infrastructure requirements of an expanding population.

A more balanced labour market
The job market remains extremely tight, with the unemployment rate at a near 50-year low of 3.7% in October 2023, significantly below the Reserve Bank of Australia (RBA)'s estimated neutral unemployment rate (NAIRU) of 4.5%. However, we anticipate a gradual loosening of the labour market, with the jobless rate likely to exceed 4% in 2024 due to more balanced labour demand and supply dynamics. On the demand side, a softer growth outlook should ease demand for labour, leading to slower employment growth. On the supply side, robust population growth, primarily through immigration, is expected to expand the workforce, allowing firms to adopt more flexible hiring and retention strategies.

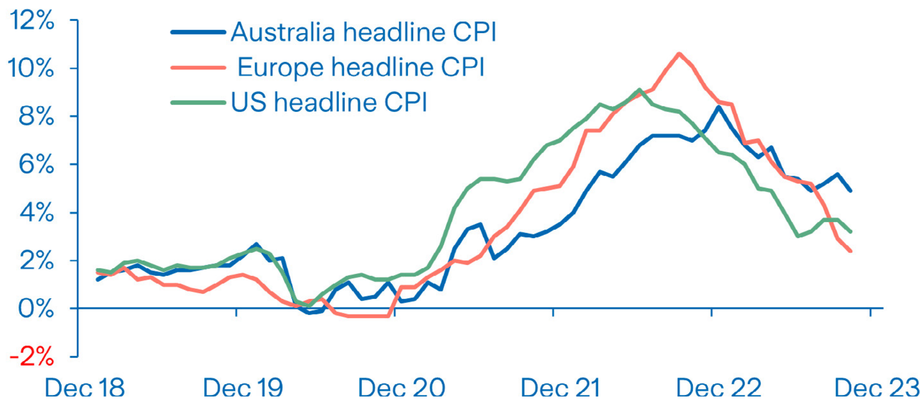
Wage growth is likely to have peaked at 4% YoY in Q3 2023 following an increase of 5.8% YoY in public sector wages with similar rises in the private sector. With inflation on a downward trend and the labour market potentially loosening, the impetus for further wage hikes seems to be diminishing.

Higher for longer
In Q3 2023, both headline and trimmed mean CPIs were above 5% YoY, surpassing the RBA's and consensus forecasts, with services inflation and rent remaining elevated. In response, the RBA increased its cash rate by 25bps to 4.35% in November after four-month pause.

While we think the cash rate may have reached its peak, there is still a risk of an additional hike in the first half of 2024 should inflation continues to overshoot expectations. The RBA is expected to adopt a 'higher for longer' policy stance, likely maintaining the elevated cash rate through the first half of the year. The timing and extent of rate cuts will largely hinge on the inflation trajectory and the degree to which demand cools to relieve price pressures. We expect rate cuts to come through by late 2024, as growth is expected to bottom out and global central banks loosen monetary policy.

Inflation to approach the RBA target range
Despite inflation being more persistent than initially thought, its downward trend is expected to remain intact. The cumulative impact of past interest rate hikes, transmitted through the continued repricing of fixed and variable rates, combined with a prolonged period of elevated rates, is likely to further moderate demand. In addition, an easing in the labour market, together with a decrease in wage growth pressures, is expected to help reduce inflationary pressures. Therefore, we expect inflation to decline steadily and approach the RBA's target range by the end of 2024.

Stickier inflation keeps the RBA on a hawkish path



Source: Bloomberg

The house price rally likely to lose momentum
House prices have defied expectations, recovering rapidly after a 9% fall from their peak and are now approaching the record-high levels of April 2022. The supply-demand gap seems to outweigh the negative impact of higher interest rates. Sharp rebounds in net migration are contributing to increased demand for housing, yet supply shortages persist as evidenced by building approvals remaining well below 10-year averages.

While the rise in house prices might have further to run, we believe the rally will soon run out of steam given that sustained higher interest rates and substantial mortgage payments are likely to temper demand. In certain market segments, particularly among low-income households, ongoing financial stress could even lead to some forced selling. Leading indicators, including a falling sales-to-listing ratio and longer times on the market, suggest that house prices might be nearing their peak.

Bond yields likely lower on the back of weaker growth and potential rate cuts
Amid weaker growth and the likelihood of rate cuts later in the year, we anticipate a further decline in bond yields. Yields on 10yr Australian Government Securities (AGS) are expected to drop from around 4.5% at the end of 2023 to around 3.5%- 4% in 2024. However, the yield differentials between AGS and US Treasuries should start to widen due to more persistent inflation in Australia and fewer anticipated rate cuts by the RBA.

On the shorter end of the yield curve, the RBA's potentially slower pace in reducing rates is likely to keep Australia's short-term rates higher relative to US rates. The difference in the timing and magnitude of rate cuts is expected to result in a relatively flatter yield curve in Australia than in the US.

Equities: A bumpy ride remains before catching wind
Australia's equity performance has been lacklustre, with markets currently trading around similar levels to the beginning of 2023 and lagging the S&P 500 and other broader developed market equities. The dominance of cyclical stocks, including financials, (mostly banks) and materials, which account for more than 50% of the ASX200 Index, has contributed to the underwhelming performance.

Moving into 2024, we expect slower economic growth will continue to dampen market performance, with the banking sector particularly challenged by weak credit growth and the balancing act of increasing deposit rates to prevent deposit flight, while not fully passing on rate hikes to mortgage customers in order to stay competitive. This results in weak earnings expectations for 2024. In the materials sector, global slowdowns have reduced commodity demand and prices, but China's economic stabilisation, especially in infrastructure, may offer a rebound opportunity despite an overall cautious near-term outlook.

In the second half of the year as economic growth reaches its nadir and rate cuts begin to inject much-needed stimulus into the economy, market sentiment is expected to improve meaningfully, leading to increased inflows into riskier assets. Given the cyclical nature of Australia's stock market, the onset of a new phase in the economic cycle could provide a considerable boost to the market.

Currency: a potential rebound by the year's end
Since early 2023, the Australian Dollar's Trade Weighted Index (TWI) has fallen by approximately 3.5%, with a 5% depreciation against the USD. This decline reflects the RBA's slower interest rate hikes relative to other DM central banks, combined with China's subdued recovery impacting commodity prices.

Due to its cyclical nature, the AUD is likely to remain under pressure amid global growth concerns and US interest rates that are higher than those in Australia, leading to a current negative carry for the AUD. However, prospects for the AUD appear more positive in the second half of the year. The RBA's recent rate hikes and expected lower rate cuts could bolster the AUD as interest rate differentials become more favourable for Australia. Additionally, improvements in China's economic growth and commodity prices, coupled with the current extreme short market positioning against the AUD, suggest potential for a rebound.

Equities struggle to find a direction

Source: Bloomberg

LatAm

Outlook

- Robust growth for the region, led by the expansion in Brazil and Mexico
- Mexico will continue to benefit from trade agreements and US nearshoring
- Inflation will continue to slow throughout the region

Implications

- Monetary policy easing to continue, though policy rates will remain above neutral
- Attractive valuations will continue to make the LatAm stock market attractive
- Equities will also be supported by Mexico's pension reform and rotation to stocks in Brazil

Risks

- Given the fiscal announcements in Brazil and Mexico fiscal deficits may arise
- In the face of expansionary fiscal policies inflationary risks could slow rate cuts
- Lower commodity prices, China's shaky recovery, and higher policy rates in developed markets

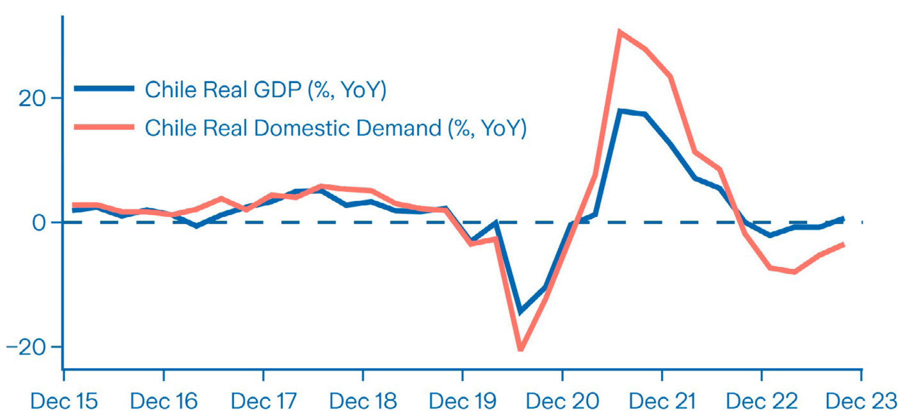
Chile: Economic activity will recover after a sharp downturn

Having experienced double-digit inflation for the 12 months between 2022 and the beginning of 2023, inflation is now in a downward trend, although it remains above the inflation target range of 2–4%. This is in a context where activity and domestic demand have continued to deteriorate, cost pressures have receded, and inflation expectations for 2025 are anchored at 3%. The downtrend in inflation has allowed the Central Bank of Chile (CBC) to reduce the MPR by 175 basis points. However, in the penultimate meeting of 2023, the CBC council moderated the pace of cuts, arguing that high volatility in global markets was a concern as were domestic pockets of stubborn inflation. Affected by the external situation, the Chilean peso has shown a high degree of volatility, with a depreciation trend that has increased inflationary risks and resulted in the pause of the central bank's program to build up international reserves (the International Reserve replacement program). We anticipate that the central bank will continue its easing cycle, although the pace of cuts is likely to be reduced and depends largely on the evolution of inflation as well as international factors that have driven global risk aversion.

GDP growth has maintained a downward trend in 2023, showing growth of 0.6% YoY in the third quarter, affected by lower domestic demand, which has been offset to some extent by an increase in net exports. Household consumption remains depressed, affected by lower spending on non-durable goods and, to a lesser extent, durable goods, but is expected to recover after the sharp contraction in 2023, supported by a gradual recovery in real wages. Investment has fallen, mainly due to a decline in inventories, but is also expected to pick up as interest rates fall and the year progresses. As a result, we expect GDP growth to improve in 2024.

The reduction of fiscal support associated with the pandemic, followed by a strong economic rebound, led Chile's general government fiscal result to a surplus of 1.1% of GDP in 2022, compared with an average deficit of -7.5% in 2020–2021. In 2023, we anticipate that the fiscal balance will have deteriorated again as the government has increased expenditures alongside a contraction in tax collection revenue due to the economic slowdown. For 2024, we expect Chile's general government deficit to be around -2.0% of GDP despite the improving growth outlook.

Chile: domestic demand should improve



Source: Central Bank of Chile

Mexico: economic activity continues to benefit from new global trade trends

Solid domestic demand has led to surprisingly strong economic activity in 2023, driven by investment, consumption, and exports. GDP advanced 3.3% YoY in 3Q and 0.9% QoQ (the eighth consecutive quarter of positive growth). Investment has benefited from capital inflows, bolstered by the USMCA (United States-Mexico-Canada Agreement) and a global reorganisation of supply chains, with industrial production remaining on an uptrend. Consumption has benefited from a healthy labor market, where the unemployment rate has maintained a downward trend to stand at 2.9% in September 2023, below its pre-pandemic level of 3.2%. Growth could be higher if not for nationalist government policies, which are weighing on private-sector investment and business confidence.

General and core inflation have continued to slow, although they remain above the inflation target. Persistent services inflation underlies Banxico's concerns about rising costs and strong domestic demand. The consumer price index increased 0.4% MoM in October, to 4.3% YoY, and when combined with strong domestic demand, which is consistent with a positive and widening output gap, it argues against cutting interest rates. It was no surprise therefore that Banxico kept the benchmark rate at 11.25% in November, and we expect policymakers to hold rates steady until early next year, when slower inflation and more moderate growth should leave room for cuts. Nevertheless, in the last meeting, a slight language tweak suggested that after holding rates steady since May, policymakers are starting to think about an initial rate cut as they wait for more data.

Among the risk factors are adjustments to the pension system, where the anticipated increase in total pension spending would reach the highest figure ever recorded. Although this fiscal impulse could boost consumption, it could also revive inflationary risks further out.

Argentina: Javier Milei, the newly elected president, will have the challenge of putting an end to macroeconomic imbalances
An economy plagued by triple-digit inflation and a currency devaluation accompanied by a series of macroeconomic imbalances, not to mention a drought that is affecting agricultural production, exports, and tax revenues, gives the president-elect a lot to contend with. We anticipate that GDP growth will show a contraction of -2.5% YoY in 2023. The trade deficit will remain in place, affected by a contraction in exports and a vulnerable current account deficit. This will increase pressure on limited international reserves. Despite the uncertainty surrounding the changes that could occur when the new government takes power, we anticipate that the economy will remain in recessionary territory in 2024, affected by a fall in consumption and contractionary fiscal policy.

Political uncertainty will continue after the victory of the far-right candidate Javier Milei, who won by a comfortable margin over the ruling-party candidate, Sergio Massa, in the presidential election. In the short term, Melei will have the task of reigning in the overwhelming inflation. During his campaign, Milei's economic proposal included: 1) a reduction of the number of ministries to eight from 21; 2) the closure or privatization of public companies; 3) tax reduction; and 4) Monetary reform, which includes the dollarization of the economy and the closure of the Central Bank. We question, however, whether his proposals can be implemented as Milei lacks majorities in Congress. In our view, most of the proposed reforms are unviable, even considering alternative routes, such as plebiscites, which must be approved by Congress. Therefore, it is more likely that the status quo will be maintained, although social tensions could constrain economic activity in 2024.

LatAm equities remain in expansive territory, aligning with the positive performance in global stock markets
LatAm stocks outperformed both developed market (DM) and emerging market (EM) stocks in 2023 amid resilient economic activity. The region is well-positioned to benefit from attractive valuations and resilient corporate results. The rate cutting cycle in Chile and Brazil should also be positive for the stock market in the coming year, despite still high rates in developed markets. In addition, greater structural inflows are being driven by the pension reforms in Mexico as well as the expected rotation of assets from fixed income to equities in Brazil. Finally, commodity prices, although they have corrected in recent months, are still above historical averages and should support LatAm equities.

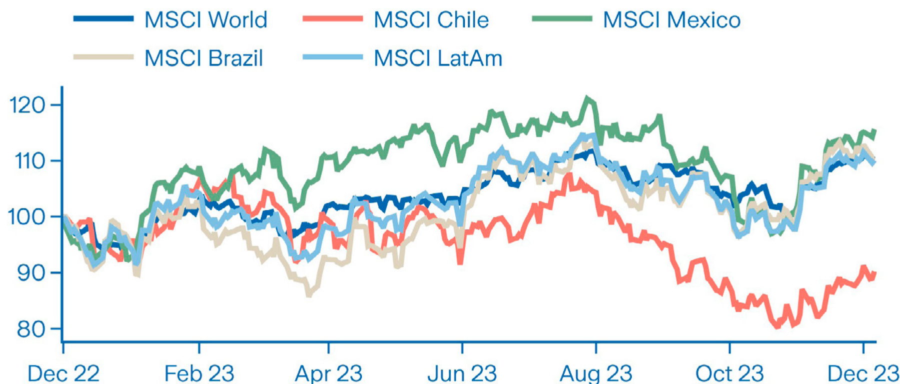
However, global risks related to a weaker recovery in China, geopolitical conflicts, and higher rates for longer in developed markets could impact the region, but the fundamentals are clear, and considering the discount in valuations, part of these risks seem to be well priced.

The Mexican stock market has outperformed other emerging market indices, driven by the strong performance of industrial, mining, and manufacturing sectors, which benefited from investment and capital inflows and were bolstered by the USMCA and the reorganization of global supply chains. A stable currency and an equity index bias towards lower beta sectors will continue to create less volatility than other emerging market equity markets in 2024. Furthermore, corporate earnings are trending higher, which should help from a valuation perspective, meaning that the Mexican market remains attractive despite the strong performance over the past two years. Nevertheless, its high correlation with the US and the less friendly policy environment for fixed investment may undermine economic activity and the value of local assets.

The Chilean stock market benefited from the central bank's MPR at the beginning of the easing cycle. We continue to believe that Chile, since the Constitutional referendum, has begun a gradual process of exiting the most complex and controversial political policies. This is reflected in a ratified moderation of the reform proposals, especially tax and pension reforms. However, companies on average continue to show contractions in their earnings, and the prices of key commodities for Chile, such as copper and lithium, have shown declines.

In Chile, the challenging global outlook will likely weigh on corporate earnings, negatively impacting the equity market. However, a quick resolution of the constitutional process and the approval of pension reforms that guarantees the continuity of well-functioning capital markets will likely boost investor sentiment. Likewise, we anticipate the CBC will continue with its easing cycle, closing at 5.0% by the end of 2024, which should also support the stock market.

Most LatAm equity markets outperform global stock markets



Source: Bloomberg (Note: Indexed to 100 on December 31, 2022)

Brazil

Outlook

- GDP growth will be solid, driven by robust agricultural exports and domestic consumption
- The gradual monetary easing cycle will continue
- Inflation will drop on tight monetary policy and lower local currency commodity prices

Implications

- A rotation is expected from fixed income to equities
- Financial assets should benefit from the cutting cycle of the CBB
- The focus will remain on fiscal prudence

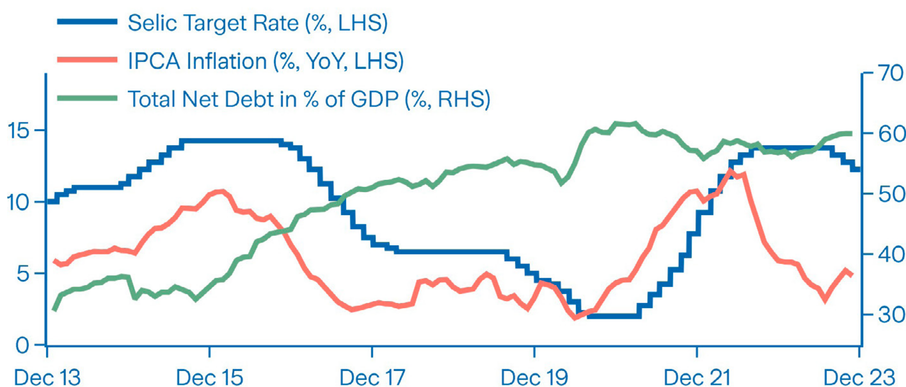
Risks

- Lagged policy impact may slow consumption more than expected
- Falling crop and commodity prices
- Fiscal slippage

Economic activity and inflation are expected to decelerate in Brazil, giving the central bank room to continue the easing cycle
Commodity prices, resilient domestic demand, private investment, and strong exports supported above-trend economic growth in Brazil in 2023. In addition, a slowdown in inflation allowed the Central Bank of Brazil (CBB) to begin the monetary policy easing cycle. Nevertheless, inflation is still above its target, and some inflationary risks remain, which could resurface given signs of acceleration in government spending. A series of reforms have been implemented in 2023 that includes a new fiscal framework seeking to improve policy predictability and medium-term debt stabilisation. The tax reform is aligned with good international practices and should boost growth. Paired with additional tax measures, it could also reduce the tax burden on the poorest part of society.

Economic activity reacted positively to Lula's third term
Consumer and investor confidence has recovered after Finance Minister Fernando Haddad proposed a new fiscal framework that eased concerns around the solvency of the country's public sector. Haddad also scored highly among investors by keeping the long-term inflation target at 3%. The new fiscal framework seeks to improve policy predictability and medium-term debt stabilisation. The labour market has also remained resilient, and new Bolsa Família parameters, including larger payments to bigger families and an extra benefit per child, have been a boost for consumption. The new fiscal rule to replace the spending cap rule was an important macroeconomic reform in 2023. The new rule was approved in August, and a couple of weeks later the economic team submitted a budget proposal to Congress for 2024 that complies with the zero-deficit target laid out in the new legislation. The government has yet to convince markets that it will deliver on it and we estimate a deficit of 0.9% of GDP in 2024, breaching the 0.25% tolerance band around the zero-deficit target given the uncertainty of the sources of revenue.

Pace of monetary easing depends on the delivery of the fiscal target



Source: Bloomberg.

Economic activity remains resilient, although fiscal consolidation and unfavourable external conditions could weigh on economic activity in 2024
A robust crop yield and higher social-program boosted Brazilian growth in the first half of 2023, offsetting the drag from tight monetary policy. GDP rose 3.7% YoY in the second quarter of the year, boosted by record-high crop yields, mining, and increased income support in the Bolsa Familia program from March onwards. This offset the countercyclical effect of the super-tight monetary policy. On the supply side, a -0.9% QoQ contraction in agriculture output was largely expected after a 21% surge in 1Q. Despite this decline, agriculture was still up 17% YoY. The industrial sector rose 0.9% QoQ, led by mining. Services advanced 0.6% QoQ, with financial services outperforming. All demand components also rose in the quarter. However, investments, key to supporting medium-term growth, posted just a 0.1% gain following a cumulative 4.6% contraction in the two previous quarters.

For 2024, we anticipate that the lagged effects of monetary policy, which we expect to remain tight through mid-to-late 2024, may curb the expansion of domestic demand while some fiscal risks have arisen after discussions about raising the fiscal deficit target to 0.25% or 0.5% of gross domestic product from the current zero goal. Without a push from a new rise in public spending and with crop prices returning to historical norms, growth may slow to around 1.5% next year, despite easing monetary policy.

The central bank will likely continue with the monetary policy easing cycle in 2024
The central bank continued its cutting cycle at its November meeting, cutting the Selic rate by 50bps to 12.75%, accumulating 150bps in cuts since the start of the cutting cycle. The board unanimously viewed 50bps as an adequate pace of cuts for coming meetings. In the announcement, they left the door open to continue with Selic rate cuts, despite the risk of higher US Treasury yields and geopolitical tensions abroad. In the domestic economy, despite some doubts about the ability to balance the budget next year, the CBC retained the same language on fiscal uncertainties it introduced in September—that delivering on the fiscal target is key to anchoring inflation expectations and thus allowing the central bank to normalise monetary policy. Inflationary pressures are expected to continue to ease in 2024 and gradually converge towards the Central Bank's target of 3% by 2025, allowing for the gradual easing of monetary policy and supporting GDP growth in 2024. The central bank will continue with its cycle of cuts, although at a slower pace, which we expect will take the Selic rate to 9.25% by the end of 2024.

The resilience of the labour market has not yet been reflected in increases in wages
The unemployment rate fell to 7.7% in September, below most estimates for the non-inflationary rate (8.5%–9.5%), suggesting the labour market is tight. However, that has not yet translated into wage pressure. While real wages have risen recently, the level of inflation-adjusted average labour income remains at the same level as in 2022. Looking forward, employment growth is losing steam and labour market participation has started to decline. That, combined with the prospect of slowing activity, points to a likely rise in unemployment in the months to come, which should help to contain real wage increases in 2024.

In 2024, the Brazilian stock market should continue to benefit from the policy easing cycle and attractive valuations
The Brazilian stock market can benefit from attractive valuations and corporate results that have remained resilient. Although the rate-cutting cycle began in the second half of 2023, the benefits have been delayed by higher rates in developed markets, but the expected rotation of assets from fixed income to equities should benefit stocks in 2024, as was the case in the first quarter of 2023. However, commodity prices may continue to decline with this sector representing close to 20% of the MSCI Brazil Index and could come under pressure as the global economy is expected to continue slowing. Furthermore, the high dividend yield and the redirecting of flows from other EMs should positively affect foreign flows to the Brazilian stock market. Also, the expected improvement in international relations with other major economies under Lula's government will be another positive driver for foreign flows into Brazil.

The combination of monetary easing by the Central Bank of Brazil and high interest rate levels makes the Brazilian fixed-income market attractive
The Brazilian fixed income market remains attractive, despite expectations that the Federal Reserve will keep rates relatively high during the first half of 2024. The 10-year government bond yield fell in November after having shown increases during the third quarter. During the fourth quarter, a risk compression was observed, measured through CDS in Brazil, which together with rate cuts boosted valuations. At the same time, the ex-ante real interest policy rate is above 6%, one of the highest globally. Furthermore, the expected monetary easing cycle will likely reverse the yield curve inversion, offering potential capital gains to investors in a market with high coupon rates. We expect the high interest rates to support flows from foreign investors who have been underinvested in the market for a long time. A key factor in controlling risk is the ability of Lula's government to comply with its fiscal rules. If not accomplished, it will likely undermine the positive carry for investors.

Despite global uncertainty, financial assets remain attractive in Brazil
All in all, we are constructive on Brazilian financial assets. The equity market seems undervalued not only compared to its historical average but also in comparison to other markets. Cheap valuations suggest political risk and global recession fears are already priced in. Considering Brazil's high beta, we expect local markets to outperform once global economic conditions improve later in 2024. Furthermore, we expect the Fed to start easing in 2024, which will likely support the equity and fixed income markets in Brazil. The higher dividend yield and carry should attract flows to local assets, reinforcing currency appreciation and reducing the currency effect on inflation. Latin America, and particularly Brazil, is gaining relevance structurally. The stock market benefits as a vehicle to gain exposure to commodities, supporting the equity and currency markets. Nevertheless, we must recognize that the level of risk is elevated, and that fiscal uncertainty may take longer to resolve, adding additional risk and volatility to the financial markets.

Interest rates for 10yr CDS and 10yr government bonds show declines in the Q4

Source: Bloomberg

Contacts

Guy Miller
Chief Market Strategist & Economist
guy.miller@zurich.com

Charlotta Groth
Head of Macroeconomics
charlotta.groth@zurich.com

Puneet Sharma
Head of Market Strategies
puneet.sharma@zurich.com

Thomas Liebi
Head of US and UK Market Strategy & Economics
thomas.liebi@zurich.com

Ross Hutchison
Head of Eurozone Market Strategy & Economics
ross.hutchison@zurich.com

Håkan Hedström
Head of Asian Market Strategy & Economics
hokan.hedstroem@zurich.com

Ha Nguyen
Market Strategist & Economist Asia Pacific
ha.nguyen@zurich.com

Diego Ignacio Valda
Head of LatAm Market Strategy & Economics
diego.valda@zurich.com

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