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Weekly Macro and Markets View

19 December 2022

Highlights and View

The Fed, the ECB, the BoE and the SNB all reduced the pace of tightening last week

While guidance was hawkish, we suspect the end of the global hiking cycle is approaching given slowing growth and moderating inflation.

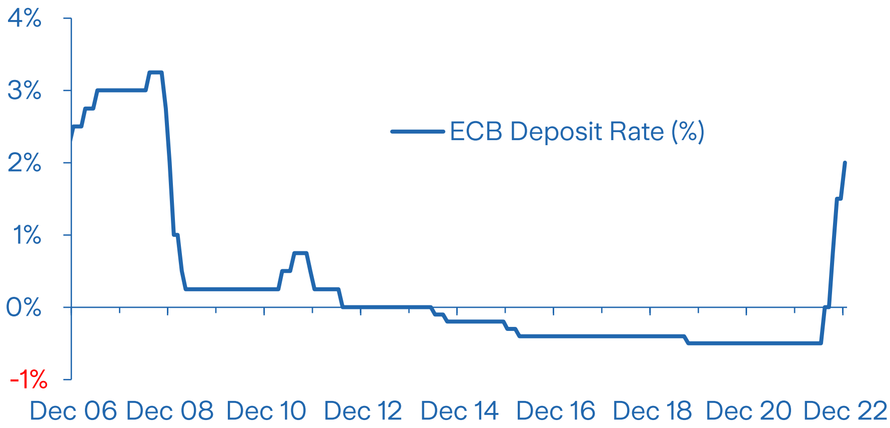
China's economy took another beating in November

We expect a bumpy road into spring before economic conditions should improve, supported by various policy measures.

As expected, the Fed hiked its target rate by 0.5% to a range of 4.25% to 4.5% while signalling more rate hikes in 2023

We expect some further tightening early next year, however, given the rapid fall in inflation and the deteriorating growth outlook it is unlikely that the Fed will be able to hike as much as projected.

The ECB's hawkish stance will be tested by markets and the economy



Source: Bloomberg

The ECB adopted an usually hawkish tone at its monetary policy meeting and press conference last week. As expected, it raised interest rates by 50bps and announced details of Quantitative Tightening (QT) to begin in March 2023. However, the guidance on the future path of policy rates was unusually hawkish. ECB President, Christine Lagarde, said "…we should expect to raise interest rates at a 50-basis-point pace for a period of time." She also said that the market expectation for the terminal level of interest rates was too low to bring inflation under control. Interest rate futures immediately repriced to include more rate hikes by the ECB, core and periphery government bonds sold off and Eurozone equities were down sharply on the day as well.

It seems that such a hawkish statement was the compromise necessary for the hawks on the ECB governing council to agree to a 50bp rate increase rather than the 75bp increment adopted in the previous two ECB monetary policy decisions. However, we think such a pre-announcement of intentions could have been a policy mistake. It is unusual for a central bank to hike interest rates so aggressively in the midst of a recession. While another 50bp hike at the next meeting on February 2 now looks likely, we think that at some point in 2023 the ECB will have to back down from its hawkish stance in the face of a weak economy and asset markets.

Markets

Central banks knock equities off support levels

As we noted last week, equities have been looking vulnerable. The surprisingly hawkish messaging from key central banks, most notably the ECB, was enough to push stocks through support levels following a half-hearted rally earlier in the week. US markets were off more than 2%, with the S&P 500 breaking through both its 100- and 50-day moving average, while the Euro Stoxx 600 fell 3.3% on the week following what had been a fairly stable month. In contrast, credit markets were quite resilient, particularly European IG credit, which significantly outperformed stocks. Government bonds were decidedly mixed, with US Treasury yields grinding lower, but German Bund yields, particularly at the front end of the curve, moved sharply higher. The 2yr yield hit 2.5% as investors digested the prospects of significantly higher and longer lasting ECB policy rates. We still believe that recession and its consequences are being under appreciated by investors and see further downside ahead for stock and credit markets, though bonds should fare better in such a risk-off environment.

China

The CEWC focuses on stability as the economic tailspin intensifies

The latest release of economic indicators for November showed that China's economic conditions have deteriorated even further from already weak conditions in the prior month. Exports and retail sales contracted sharply while industrial production and fixed asset investment barely grew in YoY terms. The latter was hit by a further deep contraction in property investment while infrastructure investment remained the only bright spot. Unemployment expanded. We expect economic conditions to remain challenging in Q1, while the outlook should brighten following an end to the zero-Covid policy provided that the booster vaccination rate improves significantly. The call for 'stability' was at the forefront of the Central Economic Work Conference (CEWC), that ended on Friday. We note that support for the private sector, including internet and property companies, appears to be a new focus. The 2023 growth target will only be released at the National People's Congress (NPC) in March, but we suspect it will be 'above 5%'.

US

The Fed lifts its target rate and the expected terminal rate

As was widely expected, the Fed raised the Fed funds rate by 0.5% to a range of 4.25% - 4.5%. At the same time, the latest projection shows that the median member of the FOMC now expects the policy rate to rise to 5.125% by the end of next year, 0.5% higher than the projection in September. Following a number of statements from different Fed members including Jerome Powell this also did not come as a surprise. Accordingly, the initial market reaction was relatively modest. Last week also brought us the latest batch of inflation data which confirm our view that inflation is falling rapidly. Headline CPI slowed from 7.7% YoY in October to 7.1% in November, below consensus expectations. Core CPI receded to 6.0% YoY from 6.3%. Importantly, the slowdown in inflation was quite broad-based with the Cleveland Fed's Trimmed Mean falling to 0.25% MoM, the lowest since February 2021 and not far above pre-pandemic levels. Finally, retail sales, industrial production and both the Manufacturing and Services PMI weakened, in line with our view that the US is heading towards recession.

UK

The BoE lifts the Bank Rate by 0.5% and signals further rate hikes

As expected, the BoE lifted the Bank Rate by 0.5% to 3.5%. Similar to earlier decisions, the vote was not unanimous as two members of the Monetary Policy Committee preferred not to change the target rate while one member was in favour of a bigger step. While further rate hikes are expected the overall tone was less hawkish compared to other central banks like the Fed or the ECB. Elevated inflation rates will keep the pressure on the BoE to tighten further in the coming months though headline CPI inflation fell more than consensus expected to 10.7% YoY in November from 11.1% the month before. Core inflation slowed to 6.3% YoY from 6.5%. Meanwhile, the labour market softened only marginally with the unemployment rate ticking up to 3.7% in November from 3.6% in October. A marked pickup in jobless claims in November to the highest since February 2021 points at further weakness in the labour market. Nevertheless, the current employment situation remains tight, which is reflected in wage growth accelerating to 6.1% YoY in October from 5.8% in September.

Japan

The services sector is doing well, supported by travel discounts

A series of important corporate surveys were published last week, including the quarterly Tankan, the quarterly BSI Business Conditions survey and the December PMIs. Without digging too much into the details, one common feature was evident: The services sector is improving further, while conditions in the manufacturing sector remain solid but are weakening following the 'V'-shaped recovery since August. The services sector is benefitting from travel discounts offered by Japan's prefectures, which have been taken up well. However, as the outlook component of the Tankan survey reveals, conditions are expected to soften going forward. Meanwhile, nearly one million foreign visitors entered Japan in November following the relaxation of travel restrictions on October 11. That is about one third of the pre-Covid level. Spending is reported as brisk, probably due to the weak yen. Most visitors come from South Korea and other neighbouring Asian countries (excl. China) as well as the US.

What to Watch

- Happy Holidays to all our readers! The ***Weekly Macro and Markets View*** will be taking three weeks off, but fear not, here are links to our ***Economic and Market Outlook 2023*** and the two accompanying podcasts, Global Economic Outlook 2023 and Financial Markets Outlook 2023.
- Coming up in the next few weeks in APAC… we do not expect the Bank of Japan to change its monetary policy this Tuesday, while Bank Indonesia is expected to lift its policy rate by 25bps on Thursday. Various countries will release CPI, industrial production, retail sales, and export statistics for November. Several markets will be closed on Monday, December 26 (Christmas) and on Monday, January 2 (New Year), while Japan's financial markets will be closed on January 2, 3, and 9.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd

Investment Management
Mythenquai 2
8002 Zurich

173008049 01/22) TCL