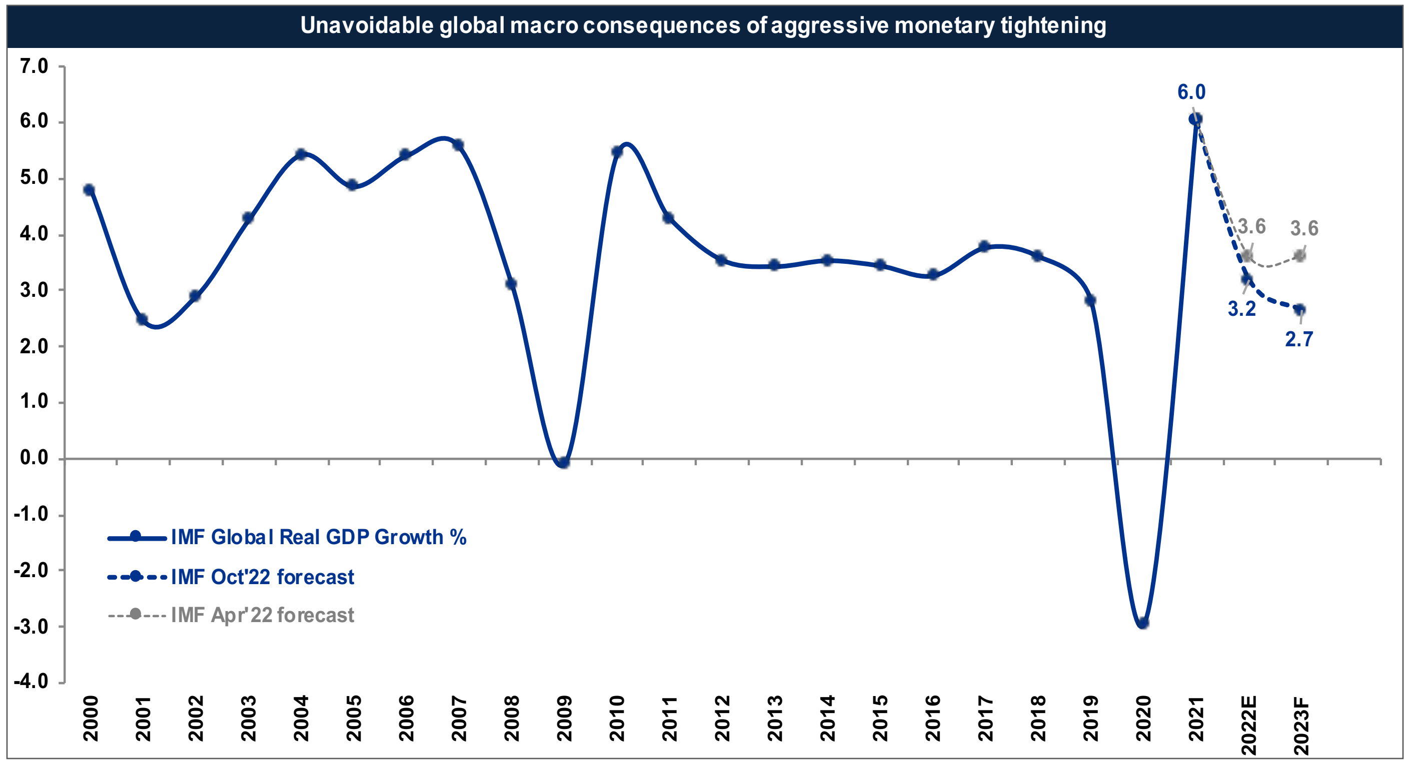
GLOBAL RATES
OUTLOOK 2023

Simon Ballard, Chief Economist, Market Insights & Strategy, FAB Global Markets

Introduction: As we head into 2023, we do so in the wake of what was a broad-based and sharper-than-expected global economic slowdown in 2022, and with inflation still running higher than for several decades. The harrowing conflict in Ukraine, the food and energy-driven cost-of-living crisis, tightening financial conditions in most geographies and the lingering Covid-19 pandemic will all continue to create challenges and headwinds for global financial markets during the course of this year.

According to the International Monetary Fund (IMF), while global real GDP growth is forecast to have slowed last year to 3.2%, from 6.0% in 2021, the global economy is forecast to experience an even slower pace of real GDP growth this year at 2.7%. In aggregate, if correct, this could be the weakest global growth outlook since 2001, excluding the global financial crisis and the nadir of the Covid-19 pandemic.

Chart: Global real GDP "The economic cost of tighter monetary conditions"



Source: IMF; FAB

At the same time, though, while inflationary pressures remain elevated for now, we do expect them to moderate from recent levels during the course of this year. Our own expectations for global inflation are broadly in line with those of the IMF that global inflation should ease to about 6.5% this year from above 8% in 2022 and 4.7% in 2021.

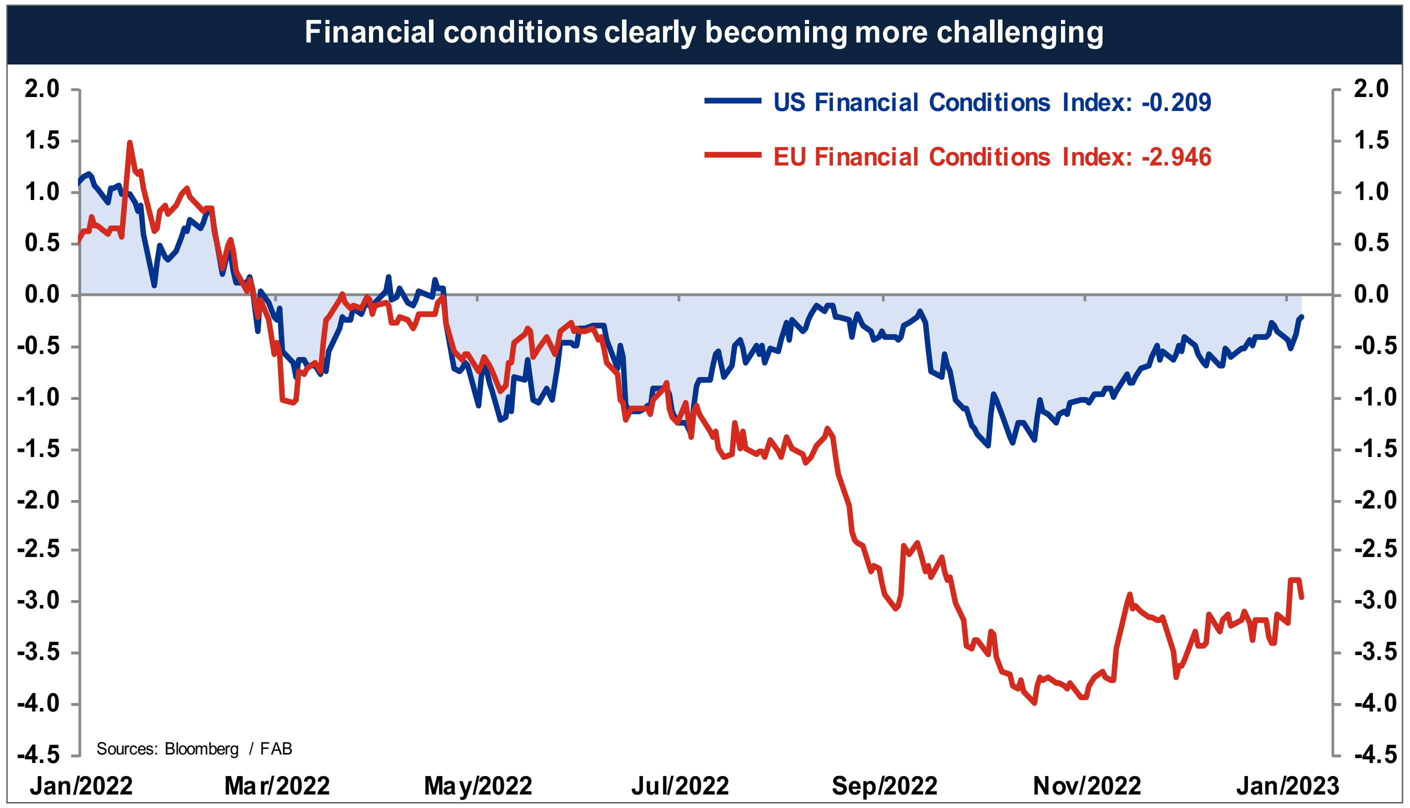
Some have suggested that structural reforms are needed to douse inflationary pressures, and that appears to have a basis in economic reality. However, such an approach is clearly more long-term in nature, and would have little direct impact on the outlook for the coming year. Longer-term efforts to reduce inflation may include attempting to improve productivity levels, and easing more persistent supply constraints.

Back to the here and now as we enter 2023, the key debate in the macroeconomic and rates environment seems to be not "if" the global economy will experience recession in the coming months, but "how deep and protracted" the said recession might be. As central banks aim to remove the last remnants of monetary accommodation from the stimulus bottle, economic growth metrics will likely come under intensifying downward pressure – and all in an effort to bring inflation under control.

Moreover, a significant risk for the global economy, and especially for the US economy over the coming months, is the lag between monetary policy adjustments to date and the effects of these being felt in the real economy. This lag has historically been shown to be as long as 18 months. As such, with the Fed having tightened in jumbo moves since only March 2022, the full effects may not be felt for several more months. In practice, central banks usually only realise they are in overshoot territory when it's too late and the economic damage is done. The very best of intentions can become a policy mistake.

The Federal Reserve, the Bank of England and the European Central Bank all need to recognise the fineness of the line between various economic scenarios. Importantly, even if we were to see a rapid and unexpected decline in prices pressures, given the depth of monetary tightening in the system still waiting to take effect, we don't believe a slowdown in economic growth (or outright recession) would be avoidable.

Chart: Financial conditions clearly becoming more challenging



Source: Bloomberg; FAB

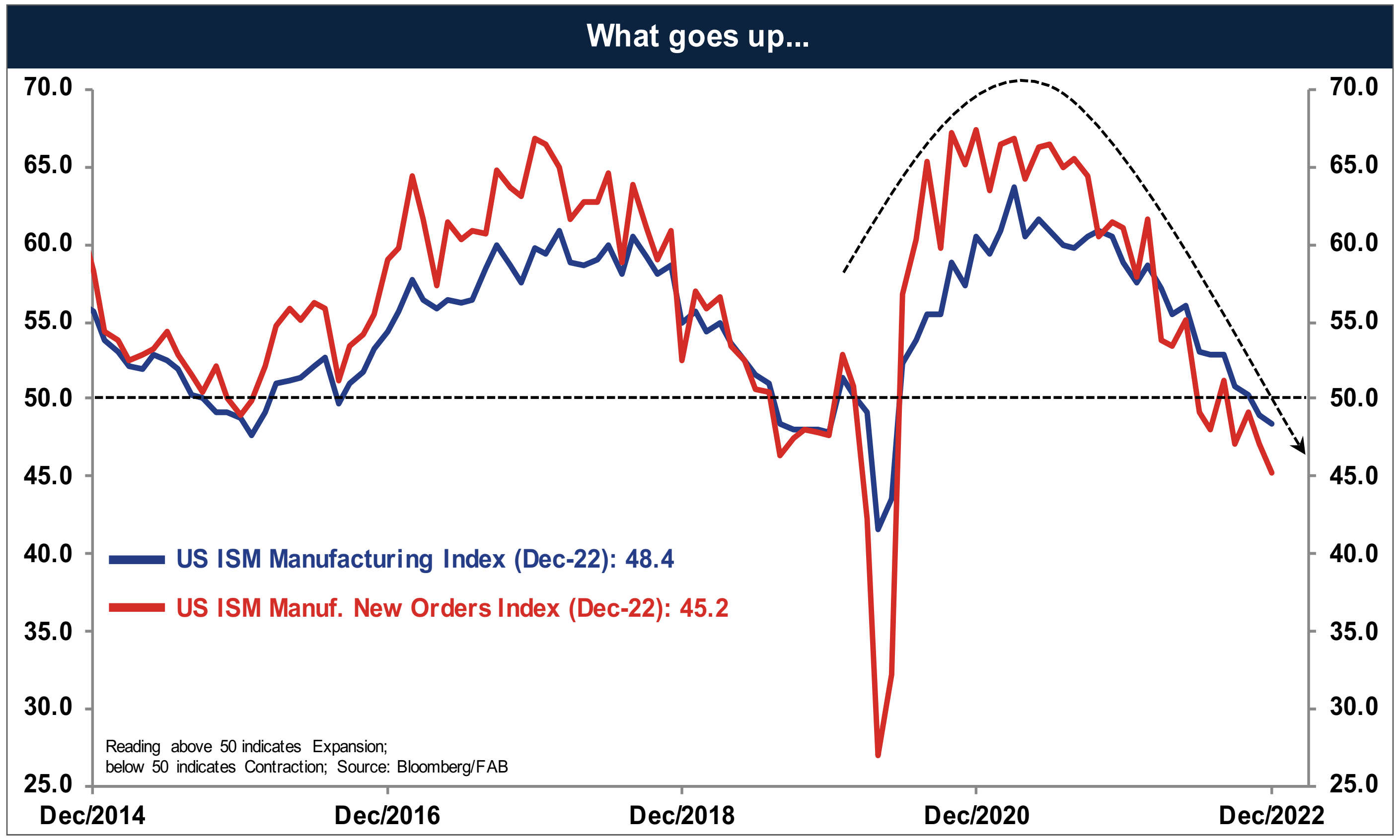
If the lag between changes in policy rates and their effects is not enough, there is a broad belief that current prices pressures are largely the result of geopolitics. Despite the fact that such factors are interest rate-insensitive, many policymakers are using higher interest rates and inducing recession in an attempt to tame the inflation monster. Yet there remains the risk of killing the patient, especially given that when rates increase, and by far less than this, more bad and unpredictable things tend to happen.

In the above context, market participants should expect fiscal policy fine-tuning to be a key tool for governments this year, to at least partially offset tightening monetary policy. This should help to assuage still heightened cost-of-living pressures while at the same time maintaining a sufficiently tight bias, yet not contradictory to, monetary policy.

Owning the Policy Mistake

US Federal Reserve officials in September 2022 marked down their economic projections, forecasting that the economy would grow just 0.2% in 2022, followed by 1.2% this year. These were sharp downward revisions from the previously predicted levels of 1.7% real GDP growth for both 2022 and 2023. As monetary conditions tighten we expect economic weakness to intensify and spread more broadly throughout the US economy over the coming months. Technically, both the US and UK economies were in recession before the end of 2022, and they could struggle to meaningfully exit this malaise during the current year.

Chart: US ISM 'What goes up'



Source: Bloomberg; FAB

The prospect of weakening economic growth, coupled with persistently high inflation readings on both sides of the Atlantic, leaves the macro outlook for 2023 with a worrying stagflation bias. This is never a positive environment for risk assets. Although we expect easing supply-side constraints, together with incremental policy tightening by the Fed and other major central banks in the next few months, to help cool inflation over the coming quarters, by then much of the rates damage will have been done.

Broad-based recession should indeed be the key characteristic of the US and Europe for much of 2023. In turn, this contraction will hit the up until now tight and robust US labour market. Unemployment there has already begun to tick higher, and this trend should have further to run in the coming months, likely taking unemployment towards the 4.5% level. That said, the latter would still be quite low, historically. In reality the jobless rate should remain fairly anchored, in part by ongoing severe labour shortages in certain sectors.

The pace at which central banks tightened interest rates and withdrew monetary policy accommodation last year suggests they should have a certain flexibility to respond as the macroeconomic backdrop deteriorates. While we do not anticipate an actual return to monetary easing before very late this year or early 2024, the expectation has been in recent months that monetary authorities would take policy deeply into restrictive territory, such that even indicating an end of the aforementioned tightening process would, in itself, be perceived as implicit easing.

As a result, we would conjecture that the current/developing recession should prove to be relatively short, and reasonably mild. Nonetheless, with inflation likely to be "sticky" and struggling to return to anything close to the traditional 2% target, we think 3%-4% will be the new annualised equilibrium "clearing" inflation rate by early 2024, central banks will be reluctant to take their foot off the tightening pedal completely any time soon. Overall, such market conditions will leave a veil of stagflation across risk assets throughout this year, albeit a welcome improvement on the severe stagflationary conditions felt in the final quarter of 2022.

US Rates Focus

We maintain the view that as US macroeconomic foundations weaken, so the Federal Reserve will moderate, and then pause, its monetary tightening cycle over the opening months of this year. The peak in the fed funds rate should be seen around the time of the 22 March FOMC meeting, or the 3 May policy meeting at the latest.

After this we expect the Fed to pause, and for rates to plateau. The next move may then be lower, but probably not until the first quarter of 2024. At the same time, we expect the Fed to persist with its quantitative tightening (balance sheet reduction) initiatives as well during the course of this year.

The latter is expected to run until early 2024, with the current monthly run rate of USD 60 billion of Treasuries, and up to USD 35 billion of mortgage-backed securities (MBS) being taken off the balance sheet each month. Conversely though, if the evolving recession proves to be deeper and more protracted than our base case assumption, or markets turn dysfunctional at any stage during the tightening process, then QT may well be halted sooner, or at least paused.

Clearly, the Fed wants to shrink its balance sheet substantially, but will be mindful of trying to avoid the kind of repo market squeeze that occurred in September 2019. At the very least we should expect the Fed to sound increasingly data-dependent in future communications, policy statements and rate decisions.

Eurozone Rates Focus

With Europe facing acute inflation pressures as a result of the region's exposure to imported food and energy costs (from Ukraine and Russia), the European Central Bank has prescribed a sharp monetary tightening timetable and warned global markets that recession may be its only option to dealing with the problem.

More worrying, though, the ECB itself has suggested that just a 'mild recession' (ECB President Lagarde speaking in Q4) is unlikely to be sufficient to deal with inflation comprehensively. Again, the central bank seems to be advocating a strategy of inducing a deeper and more restrictive economic downturn. To this extent the futures markets are now pricing a near-doubling in ECB benchmark rates, which have already been hiked sharply from zero over the latter half of last year.

How feasible such an outlook will be remains to be seen. The market may be getting a little ahead of itself, and the ECB may soon see the error of its ways if it continues to advocate a blinkered approach to rates and inflation.

The ECB will probably persist in tightening well into the first half of this year, but as monetary conditions tighten and become more restrictive we would expect it to sound increasingly data-dependent and nuanced in future policy statements and rate decisions.

UK Rates Focus

With UK inflation having surged to multi-decade highs last year, the Bank of England has reacted with a draconian monetary tightening process that has now left the UK facing a recession this year. Indeed, BoE Governor Bailey himself warned late last year that the UK now faces up to two years of recession as the Bank keeps its foot on the inflation windpipe.

However, in similar fashion to our US and, to a certain extent Eurozone, outlooks, we believe that markets got ahead of themselves in 2022, and a marginally less hawkish narrative will play out this year.

Nonetheless, for now we are left with a somewhat more hawkish rates outlook for the UK compared to those of the US and Eurozone. Indeed, UK rates may not top out until the second half of this year as the BoE ignores the deteriorating macroeconomic landscape and continues to push ahead in trying to extinguish (what we have already stated) are largely interest rate-insensitive inflation pressures.

As the UK macroeconomic foundations weaken it will be increasingly difficult for the BoE to ignore them. The market should then pare back any further overly hawkish additions that get factored into futures pricing in the coming months.