Forecast
Market Outlooks

Q1 2023

Forecasts Quarter 1, 2023

Global Economic Outlook

Simona Mocuta
Chief Economist
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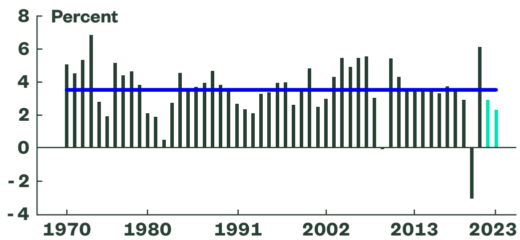
Figure 1
Global Growth Revised Lower for 2023



World Real GDP Growth (WEO)

World, Real World GDP, State Street Global Advisors Forecast

Long Term Average Growth (3.5%)

Source: IMF, WEO, State Street Global Advisors, as at 31 December 2022. The above forecast is an estimate based on certain assumptions and analysis made by the State Street Global Advisors Economics Team. There is no guarantee that the estimates will be achieved.

- Global growth will slow into 2023, with US and European growth not much above zero. Risks are to the downside with sub-trend growth extending into 2024.
- Amid improved supply and slowing demand, a powerful disinflationary episode takes hold. More favorable inflation data could see the Fed cut interest rates late this year.

Emerging Markets Outlook

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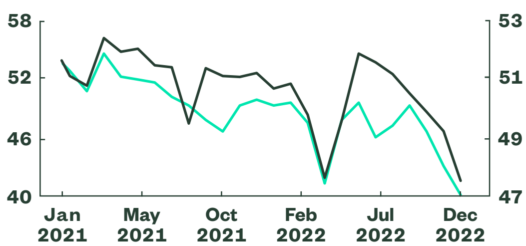
Figure 2
China PMIs: Up From Here?



Non-Manufacturing PMI, Business Activities Index (lhs)

Manufacturing PMI (rhs)

Sources: Macrobond, SSGA Economics, China Federation of Logistics & Purchasing as of January 20, 2023.

- Amid lowing global demand and constricting monetary policy, the economic backdrop for emerging markets (EM) remains difficult.
- China's reopening should boost EM growth performance, but risks remain.

Global Capital Markets

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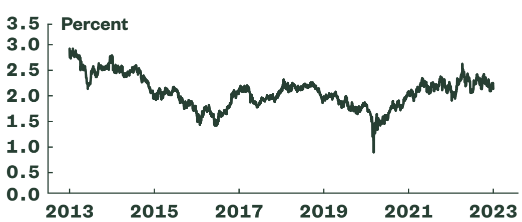
Figure 3
5-Year, 5-Year Forward Inflation Expectations Rate, % Daily (not seasonally adjusted)



Source: States Street Global Advisors, Federal Reserve Bank of St. Louis as of January 13, 2023. Past performance is not a reliable indicator of future performance.

- Financial market oriented signals point to an improving backdrop for capital markets just as economic growth in advanced economies is poised to straddle weak or recessionary conditions — leading to a tenuous balance of risks.
- Bond markets present opportunities across geographies, maturities and sectors. We prefer allocations to cash and government bonds (US and non-US) to take advantage of current carry and defend against slowing economic growth.

Global Economic Outlook

Simona Mocuta
Chief Economist

As 2023 gets underway, there are two main macro narratives competing for attention. There is a soft landing type of scenario that is predicated on a constructive view of inflation, and a harsher, bumpier, if not outright hard landing scenario.

The soft landing scenario calls for a powerful disinflationary episode to unfold early and convincingly enough to facilitate a more dovish pivot by central banks before they cause genuinely crippling damage to labor markets and tip the global economy into outright recession. In the harder landing scenario, insufficient progress on inflation forces central banks onto an even more aggressive tightening path that causes something in the economy to break. That the crack may not first appear in the labor market (given the strong starting point) only emboldens policymakers' hawkish stance. However, something, somewhere, snaps and triggers a chain reaction of financial market stress that then reverberates through the real economy, driving an abrupt shift from the appearance of resilience to the threat of failure.

We still favor the first scenario but are less confident than three months ago. The latest signals from key central banks remain very hawkish in spite of what we consider to be clearly improving leading indicators of inflation. The risk of overtightening has risen considerably. Elevated borrowing costs in the context of rapidly diminishing excess savings, vanishing pent-up demand, little room for fiscal expansion, and ongoing geopolitical tensions, create a dangerous backdrop as we enter 2023.

We anticipate global growth slowing sharply from 2.9% in 2022 to just 2.3% in 2023. However, we haven't reduced our 2023 growth forecasts for either the US or eurozone 2023 since September. But softer growth profiles for the UK, Canada and Australia have prompted us to lower advanced economy growth by two tenths, even as Japanese growth has been revised upward.

China remains a source of resilience in the upcoming year on reopening expectations even though we've trimmed the 2023 growth forecast slightly to 5.0%. Downgrades to several other economies flatten the anticipated rebound in emerging market (EM) growth in 2023. All in all, this is a high risk moment for the global economy as central banks struggle to engineer a soft economic landing.

United States: Pushing on a String

Following a reopening-induced 5.9% growth surge in 2021, the US economy was on a clear decelerating path through 2022. The slowdown will extend into 2023, when we expect the economy to grow a mere 0.4%. This is the same projection we made in September, which may seem surprising given how much has happened since then. The better-than-expected third-quarter GDP outturn forced a slight upgrade to our 2022 estimate (now 1.8%), but the broad contours of incoming data are well aligned with what we expected to see. As such, rather than minutely tweak the 2023 forecast, we will wait and see whether more substantive adjustments will be needed in March.

We note that the consensus growth forecast for 2023 consensus has shifted to our position. Back in September, our 0.4% forecast was half the Bloomberg consensus, but it now sits right on top of it. The narrative is the same as three months ago: a material slowdown in consumer spending and slower inventory accumulation offset a better trade picture. With the household savings rate hovering near record lows, this view remains convincing. The slowdown in inventory accumulation was also clearly visible in the third-quarter GDP data, as was the improvement in net trade. Although the latter is unlikely to sustain the degree of improvement shown in Q3, we anticipate the real trade deficit to narrow in 2023.

The investment picture is mixed. There has been a massive recalibration in the housing market, with residential fixed investment down nearly 8.0% year-on-year (y/y) over the first three quarters of 2022. Further declines are likely but the rate of contraction should slow in 2023, if for no other reason than more favorable base effects. Other areas of investment have shown an impressive degree of resilience. Whether due to delayed improvement in global supply chains (e.g. automotive industry), resumption of output in select areas of air transportation equipment, or the broadening drive towards reshoring, capital goods orders held up well in 2022. That said, order growth is slowing so a deceleration in non-residential private fixed investment seems inevitable. But this slowdown need not be severe given what appears to be decent fundamental demand for capital expenditure (replacement, expansion, and greenfield). Rising borrowing costs are a risk to the outlook, however, warranting close attention.

Wages Key for Inflation Prospects

The labor market is both a blessing and a curse at the moment. A blessing insofar as robust labor demand suggests little rise in unemployment over the next several months. A curse in as much as robust labor demand also suggests a very slow moderation in the rate of wage inflation, which the Federal Reserve considers too high. The question remains whether labor demand can be compressed just enough to take the steam out of wage inflation without damaging employment too much — it may well be possible. Although there still are about ten million job openings in the US, openings have come down a lot at firms with 50–1,000 employees. Where there has been little movement so far has been in the small business segment, i.e., firms with less than 50 employees and particularly those with less than 10 employees. Even if hiring were to continue apace in this area of the market, we suspect these jobs come with lower average pay; there could be a compositional shift in the jobs created over the course of 2023 that may facilitate slower wage inflation despite elevated employment levels. Wage dynamics will likely decide whether the soft landing remains softish or turns harder.

Inflation remains a major source of frustration, not only because it is still unacceptably high, but also because a huge gap has opened between current inflation numbers and leading indicators of inflation, all of which show powerful disinflation unfolding. In turn, this has perpetuated tensions between markets pricing in an easing of the Fed Funds rate from late 2023 and the Federal Open Market Committee (FOMC) that continues to push vehemently against such expectations.

Fed to Cut in 2023?

We are somewhat perplexed by the FOMC's incremental hawkishness despite growing evidence that the inflation tide is turning. Earlier in 2022, it was understandable that the FOMC would lean hawkish; at that time, the disinflation evidence in the pipeline was much more limited. But now it is almost overwhelming. Whether one looks at commodity prices, measures of supply chain pressure, purchasing managers' index (PMI) backlogs, pricing intentions in survey data, house prices and incremental rental costs, all have turned sharply lower. It will take time for these to show up in the consumer price index (CPI) — especially the shelter part — but even the longest lags do not last forever. To put things in context, our forecast has headline US inflation dipping below the 3.0% y/y mark in the fourth quarter of 2023. If that proves correct, a Fed Funds rate of 5.0%+ as envisioned in the latest "dots" of Fed member estimates would be too high. Perhaps that is why the market pricing for rates barely changed following the December Fed meeting; it is also why we side with the market in expecting rate cuts before the end of 2023.

Eurozone: Against All Odds?

For a region likely facing the worst combination of macro risks, two surprising things happened during our latest forecast update for the eurozone. Firstly, we upgraded the 2022 growth forecast to 3.3% (versus 3.0% in September). And secondly, we left the 2023 forecast unchanged at 0.3%. In doing so, we moved more above consensus, which has retreated slightly in the past several months to stand at -0.1%. There is a fairly wide range of views around that outcome, however, so we are by no means an extreme outlier.

Our relatively more optimistic outlook on the eurozone has rested on the dual pillars of a more constructive view of the region's energy supply situation, and a similarly constructive view of demand conditions. We had been stressing the excess savings cushion and beneficial re-opening effects as drivers of services demand. Indeed, real GDP grew 4.0% y/y during the first nine months of the year, with household consumption up 5.0% y/y, fixed investment up 4.6%, and exports up 8.1%. The 0.3% quarter-on-quarter (q/q) contraction assumed in Q4 still leaves 2022 growth at an impressive 3.3%.

Both factors continue to favorably shape our 2023 outlook. Although natural gas storage levels are now declining from near 100% capacity as colder weather lifts heating demand, the storage cushion remains elevated. This has a two-fold positive effect as it reduces both the severity and the likelihood of a downside scenario that involves energy rationing and broad shutdowns of industrial capacity. We also assume continued improvement in manufacturing supply chains — particularly in the automotive sector — that should help Germany and Italy in 2023. China's exit from zero-Covid policies has the potential to fuel another wave of pent-up tourism over the summer, just as in 2022. Although the situation is challenging, we believe that the three percentage point sequential slowdown in growth between 2022 and 2023 appropriately reflects the balance of risks. Our 0.3% expansion forecast is as weak as it gets this side of contraction.

Inflation Remains in Focus

The inflation problem remains acute and, compared to the start of 2022, there is more evidence of wage acceleration, raising concerns that a price/wage spiral could develop. The prevalence of wage indexation in Europe vis-à-vis the US raises risks as it makes wage inflation stickier. So while it may take longer for wages to respond to higher inflation (as seen in 2021), they can also take longer to moderate once the inflation shock abates, and in the process delay or even prevent the full normalization in both. This merits close attention over the next couple of years but we are also weary of premature panic. After all, a disproportionate share of the eurozone's inflation spike reflects a supply shock that ameliorates over time. Admittedly, the magnitude is so intense and the healing process delayed enough that, having topped double-digits in October–November 2022, annual average inflation in 2023 is still likely to be in the neighborhood of 5.5%. By 2024, however, a full-on deflationary episode should be unfolding.

ECB Playing Catchup

The ECB is in a belated rush to tighten policy to fight inflation. It made it clear at the December meeting that it intends to move policy rates well into restrictive territory. We expect the terminal rate to approach 3.5% during this cycle. Concerns around financial stability could quickly escalate, precluding the delivery of ECB's hawkish promises. However, evidence of accelerating wage inflation would likely heighten the Bank's resolve, leading to higher rates and possibly a worse growth outcome.

United Kingdom: And so it begins...

The UK economy fared better than generally expected in 2022; indeed, we upgraded our 2022 growth estimates. However, UK growth seems poised to underperform its developed market peers in 2023. Given the 0.7% contraction in real GDP we expect in 2023, the UK forecast is officially calling for a recession.

Given the magnitude of the deceleration, from 4.4% growth in 2022 to a contraction this year, it should be no surprise that the slowdown is broad-based. Amid elevated inflation (averaging 10.4% y/y since July), consumer spending likely declines outright in 2023. Fixed investment should prove slightly more resilient but slows markedly as well, while the massive inventory accumulation cycle of 2022 gives way to decumulation in 2023, further hurting growth. The trade picture improves as imports slow, but that may not be enough to offset weakness elsewhere.

More Dovish Than The ECB?

Perhaps the brightest spot across the UK economic landscape is the labor market. Unemployment remains very low, with the latest print of 3.7% still better than it was even as recently as last summer. However, the labor market is loosening at the margin and labor demand is slowing; vacancies have been steadily declining since June. But as in the US, limited labor supply may put a ceiling on the expected rise in the unemployment rate. Wage inflation remains elevated — 6.1% y/y as of the latest update — driven heavily by rapid wage gains in the private sector, something that needs to moderate in order to facilitate a timely return of inflation to target. The process, however, may take a while, leaving the Bank of England in a difficult position.

The BoE has been consistently more dovish than the Fed but is now at risk of sounding more dovish than even the ECB. However, the underlying view that the spike in inflation is primarily the result of an external shock that will fade, and that policy should be anchored on expected inflation going forward, do resonate well with us. More hikes are in store following December's 50 bps hike that took the Bank Rate to 3.5%, but we continue to view a move to 5.0% in 2023 as a step too far. The current market pricing of about 100 bps of hikes seems more reasonable.

Japan: Turning Optimistic

We are optimistic about Japan withstanding the global downturn in 2023. The economy will still slow, but we expect domestic consumption — aided by better wages and government support — to offset the slowdown in external demand. The resiliency in growth would put the focus on the Bank of Japan (BoJ). An inflection point in BoJ policy that saw it raise the yield cap to 50 bps on its yield curve control policy has certainly introduced a new source of uncertainty.

Inflationary pressures are clearly building. The core-core CPI (or the BoJ core, namely CPI ex fresh food and energy) rose above 2.0% y/y in October for the first time in three decades. Most of the inflation was caused by goods but we expect the baton to be passed to services, which have acted as a constraint on inflation due to government travel and energy subsidies. These categories will however lift inflation from the second half of 2023. We also anticipate some demand-driven inflation such that headline CPI inflation averages 2.4% in 2023 and remains elevated in 2024.

Services inflation is well correlated with wages, making wage growth key for sustained inflation. Nominal cash earnings rose 1.7% y/y in Q3 and 1.8% in October, above the pre-pandemic three-year average of 0.6%. Furthermore, the tight labor market is expected to yield better pay amid evidence more workers are looking for new jobs while the unemployment rate is at a historic low. These dynamics will contribute to better outcomes during the 'shunto' wage negotiations and should keep wage growth above 2.5%.

Bank of Japan To Edge Towards Normalization

We expect the BoJ to move to normalize policy in 2023. The first step towards this was raising the target of the 10-year JGB yield to 50 bps from 25 bps. As with previous tweaks to the YCC policy in 2018 and 2021, the BoJ clarified that the change was different from easing monetary policy. Even so, stronger economic fundamentals would justify a steeper yield curve in Japan. Should the economy continue recovering with sustained wage momentum, it warrants exiting the negative interest rate environment in due course.

We expect fiscal policy to remain expansive, as was evident in the recent supplementary budget. Although most of the allocation was made to existing policies, nearly 1% of GDP was allotted to electricity subsidies from Q2 2023 when prices are expected to rise sharply. As the timing will coincide with wage increases, we expect the overall outcome to support consumption. The travel subsidy program is another important tailwind for domestic demand.

On the growth front, we expect domestic demand to be anchored firmly by two factors. Firstly, pent-up demand for services consumption will be bolstered by increased tourism following the lifting of restrictions on incoming travellers. Secondly, pandemic-induced current savings rate of 5.4% is significantly ahead of the pre-pandemic level of 1.4%. Growth will be further aided by the positive momentum in capex, as reflected in the December BoJ Tankan Survey — large firms' plans were slightly revised down to 19.2% but remained the highest in a decade. However, we worry that production momentum will be challenged by slowing external demand. Although domestic demand should be robust, production in segments that were affected by tight supply chains such as autos should recover. These factors should support GDP growth to an average 1.5% y/y and 1.1% in 2023 and 2024, respectively.

Emerging Markets: A Fragile and Modest Improvement

Simona Mocuta
Chief Economist

China's removal of most pandemic-era restrictions provides a tailwind for the emerging markets universe as 2023 gets under way. However, global demand conditions remain uncertain and sentiment among consumers, businesses, and investors continues to be fragile.

Given its share in the EM aggregate, China always exerts a major influence on the group's economic fortunes. Thankfully, this year this influence is likely to be a favorable one. Despite near-term challenges as the country adjusts to the reality of living with Covid, we anticipate China's economic growth to accelerate noticeably as pent-up consumer demand for services has a chance to materialize more fully. Some of the benefits will — with a lag — flow to other economies as well, not only to tourism-dependent EM countries but likely also to Europe and other foreign destinations. Even so, considerable challenges remain, particularly with respect to reviving the domestic real estate sector. On the trade front, the ongoing shift in consumer spending patterns in key export markets away from goods and towards services is not a favorable one for China.

The outlook for the rest of the EM country universe remains mixed. Some relief on the inflation front, and likely some relief on interest rates as central banks pause the hiking cycle and eventually starts dialing it back in places is a positive. However, this normalization process will take time to unfold and occurs in the context of uncertain global demand conditions, blunting its positive impact. On the downside, geopolitical risks still abound and sentiment — among consumers, businesses, and investors — remains fragile. Perhaps this is a good way to think about the EM outlook this year: a fragile, and modest, improvement.

Global Capital Markets Outlook

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Typically, in the economic and financial predictions business, we tend to focus on relatively near-term outlooks. Analyst expectations for earnings across equity markets generally don't venture past 2025 at the moment. The US Energy Information Administration (EIA) offers up oil price expectations out to 2024. In this publication, we take on a shorter, though no more predictable, horizon that focuses on the year ahead (albeit with quarterly revisions).

(In)credible Times

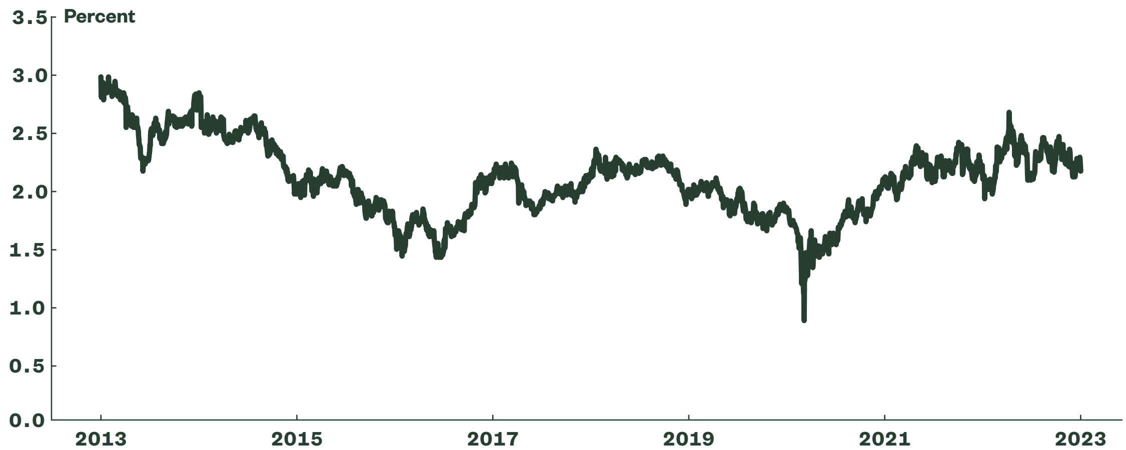
However, we open our Q1 2023 Forecasts edition with a longer-term, high-conviction, but probably less remunerative, prediction. When the Federal Reserve releases the transcripts of today's Federal Open Market Committee (FOMC) meetings sometime in 2028 or 2029, one of the most prominent terms that the natural language processing algorithms will turn up, after "inflation" of course, will be "credibility." Central bankers are well attuned to the importance of maintaining credibility. Not unlike the quotation often attributed to Benjamin Franklin that "It takes many good deeds to build a good reputation, and only one bad one to lose it," Mario Draghi put a central banking spin on that message in 2011:

"Gaining credibility is a long and laborious process. Maintaining it is a permanent challenge. But losing credibility can happen quickly — and history shows that regaining it has huge economic and social costs.[1]"

The economic and social costs associated with losing credibility are not always and everywhere a monetary phenomenon, however. Legislators and fiscal authorities would do well to take Draghi's words to heart, lest they wind up like recent inhabitants of 10 Downing Street, or find themselves seeking aid from the International Monetary Fund (IMF). Cryptocurrency participants and exchanges are learning just how quickly reputations and fortunes can be lost, and how altruistic motivations can be rendered ineffective along the way. By contrast, today's central bankers appear to be doing everything they can to avoid the huge costs that might arise should they lose credibility in their battle against inflation. As noted in our economics coverage, central banks remain hawkish despite broad improvements in inflation signals. This is all the more surprising given how stable market-based measures of inflation expectations have been over the past two years (see Figure 4). Should we, as investors, take them at their word? We'll look to answer that and other questions in the rest of this piece — coincidentally putting our own credibility on the line in the process...

Figure 4
Inflation Expectations Notably Stable Through 2021–2022

5-Year, 5-Year Forward Inflation Expectations Rate, %, Daily (not seasonally adjusted)



Source: State Street Global Advisors, Federal Reserve Bank of St. Louis as of January 13, 2023. Past performance is not a reliable indicator of of future performance.

Risk Regimes Finally Relenting

The turn into 2023 seems to be setting up as one in which more muted risk regimes may be pointing towards a better environment for share prices. Our Market Regime Indicator (MRI) spent nearly all of 2022 in high risk aversion or crisis risk regimes. It wasn't until the US dollar peaked in the fall that we saw the first meaningful shift towards easing investor sentiment. The interrelated improvement in longer-term interest rates and the ongoing accumulation of evidence that worst-case inflationary outcomes will likely be avoided also contributed to the easing of our proprietary signal. Importantly, however, we should note that we've yet to see risk sentiment breach the thresholds that we would consider a clear buying opportunity for riskier assets. To us this makes sense. Market developments appear to be moving in the right direction, but our growth expectations are depressed and there remain uncertainties associated with the digestion of 400–500 basis points of interest rate hikes — more than enough to pause and think twice about any volatility or vicissitudes that might lie ahead.

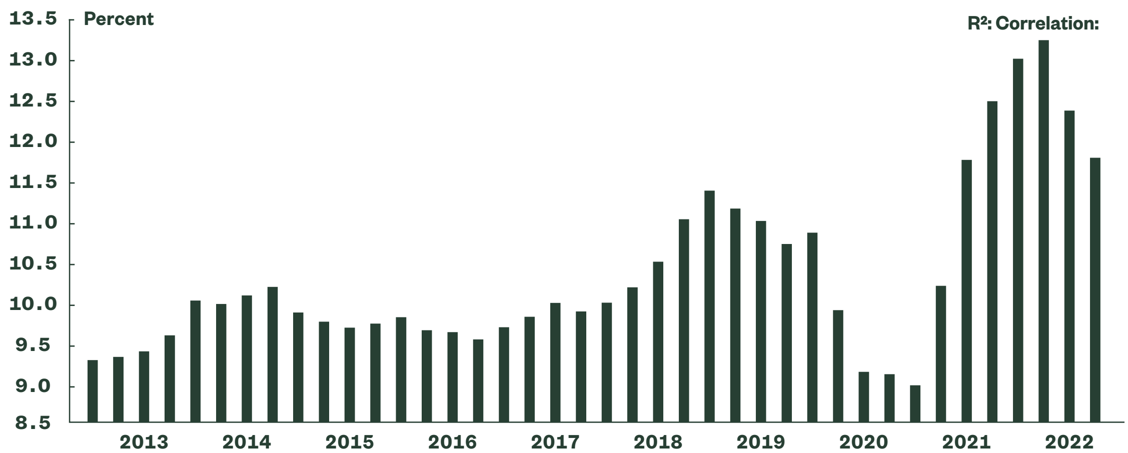
Global Equities: Top Line vs. Bottom Line

With China reopening, the Fed slowing its pace of rate hikes, and concrete evidence that inflation is rolling over, investors appear to have become a little more amenable to risk, which suggests a favorable backdrop for equities in our regime-aware framework. This positive development was further confirmed by our underlying directional alpha model that ranked global equities near the top of the list, bested only by commodities as of year-end. However, if we look at the signals that add up to this positive aggregate score, a more nuanced outlook for equity markets begins to emerge.

The October–November rally that drove the S&P 500 7.6% higher in the fourth quarter improved price momentum scores. While this price strength pushed valuations a bit higher, the overall value score stayed in positive territory as markets are still priced well below the lofty heights reached a year ago. Earnings quality factors remain well supported by stable operating returns and leverage indicators, indicating a healthy foundation to anchor future earnings expectations. These positives were, however, partially offset by weaker sentiment scores, driven by deteriorating earnings and sales revisions, and negative macro-economic factors such still elevated credit spreads and weaker flows by active managers. While these reflect modest negatives compared with our overall constructive assessment — not forceful messages to cut equity risk — it is worth keeping those potential red flags in mind. This is especially the case if equity markets become overly fixated on an eventual Fed pivot or fail to reflect the negative impact that lower price inflation may have on top line growth while the lagged effect of input cost inflation continues to squeeze margins.

Figure 5
Input Cost Inflation Begins to Squeeze Margins

S&P 500 Net Margins (2013–2022)



Source: FactSet as of December 31, 2022.

Within equity markets, a continued preference for value over growth exposures continues to characterize our sector and regional positioning. On the latter, we have relatively less exposure to the United States and emerging markets and have chosen to express our positive equity outlook though an overweight to European and Pacific equities. Although these regions have a lot of challenges ahead, local equity markets have begun to reflect a more constructive outlook while valuations remain attractive. Furthermore, as the USD rate advantage begins to erode and other central banks ramp up their tightening efforts, a weaker US dollar could boost returns for unhedged-USD investors. From a sector perspective, consumer staples and financials remain favored sectors while materials was upgraded to a full allocation as dollar weakness helped improve price momentum while sentiment and attractive valuations help bolster our forecast for materials. Our forecast for the energy sector — a past favorite — remains positive with robust price momentum and favorable valuations, but a drop in sentiment, both earnings and sales, led us to remove the sector from our top three.

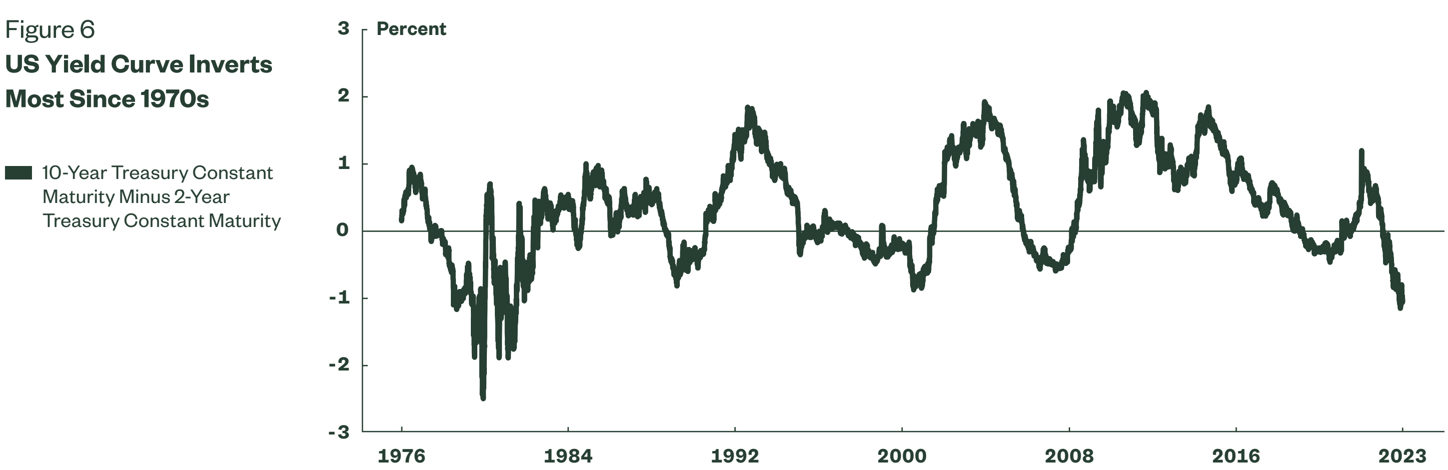
Bond Markets: Tight Breakevens, Wide Opportunities

If we just consider market-priced measures of longer-term inflation expectations, one might scoff at the idea that the Federal Reserve or other central banks should be concerned about their credibility. Long-term inflation expectations in the United States, as measured by 5-year/5-year forward breakevens, barely scratched 2.5% as broad-based price indices were approaching double-digit rates of inflation. And with nominal interest rates at their highest levels in more than a decade, bond markets look much more attractive than they have in years. Our own capital market assumptions for many sectors of US bond markets jumped by more than 3% over the past year. But where lies the best value in fixed income, especially as the risk/return calculations for equities are also much improved?

Some investors might look at the 4–5% interest rates on offer in cash and short-term fixed income assets and conclude there is little need to introduce additional interest rate or credit risk at the moment. And in some respects we would agree with that perspective as we hold a sizable overweight to cash in our portfolios. But even if that is the case today, we shouldn't lose sight of the fact that those premium returns at the short end are likely to be fleeting and preparations should be made for when sitting tight in cash is not as compelling a proposition.

In that respect, our view for US Treasury yields has shifted to anticipate a steepening curve over the near term after anchoring around a flattening trend for the better part of the last two years. The change in expectations is driven by our fixed income research whereby a series of growth, inflation, and momentum indicators have all started to suggest that short-term interest rates are plenty tight already. Our proprietary set of leading economic indicators is sufficiently mixed to have cooled down from 2021 and 2022 — notwithstanding ongoing strength in labor markets. Inflation expectations, this time from a consumer perspective, have also backed off and suggest less of a need for tight policy. And slope momentum has shown slight indications that change may be afoot. That the curve (as measured by two-year and 10-year Treasury yields) has also inverted further than at any point since the late 1970s and early 1980s provides another marker that there may be a limit to how far the curve can invert (Figure 6). It is true that the yield curve experienced much deeper inversion during the great inflation of the 70s and early 80s; however, we don't think that period is as useful for evaluating today's inflationary risks — at least in as much as the yield curve is concerned. For one, inflation expectations today are nowhere near as entrenched as they were during the great inflation period. Additionally, it's important to remember that the Federal Reserve was only loosely targeting the federal funds rate during that time as they managed the money supply to try to get inflation in check — no surprise then that short rates exhibited so much volatility.

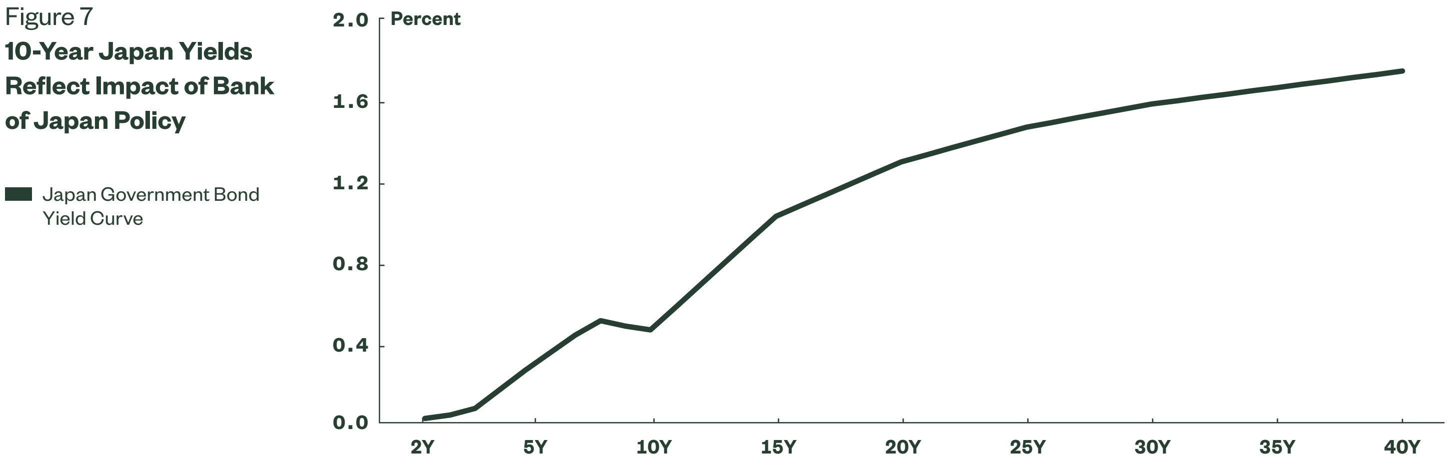
Figure 6
US Yield Curve Inverts Most Since 1970s



Source: Federal Reserve Bank of St. Louis as of January 13, 2023.

Yield curves in other parts of the world also depict interesting shapes while posing unique risks. The yield curve for Japanese government bonds now has a distinct kink at the 10-year point — something that has grown more pronounced in the wake of the Bank of Japan's relaxation of its yield curve control policy in December (see Figure 7). While this kink may amplify interest rate risk for the benchmark 10-year bond, the broader risk would be higher interest rates that have destabilizing effects both in Japan and abroad. After all, between Japan and the United States, those two countries represent more than 50% of global government bonds.[2] And in Japan the average duration of those securities is nearly 10 years. With monetary policy still an outlier across developed markets and inflation continuing to accelerate, the outlook for Japanese government bonds is less compelling than other markets in our view. But if there is a silver lining, at least for unhedged investors in the country's bond market, it's the potential ongoing strength in the yen that would likely result from additional movements away from yield curve control. As a case in point, when the Bank of Japan widened the bands within which they would allow the 10-year yield to trade, Japanese government bonds lost about 0.5% on the day. Meanwhile, the yen advanced by 4%. For our part, non-US government bonds overall look relatively attractive, but much of the benefit is likely to come from improving foreign exchange rates.

Figure 7
10-Year Japan Yields Reflect Impact of Bank of Japan Policy



Source: Japan Ministry of Finance. Data as of 12/30/2022.

While we see non-US dollar currency exposure as an additive risk factor in the near term, the same cannot be said for credit assets, at least from a multi-asset standpoint. Higher prevailing nominal interest rates may well prop up long-term asset class returns for bonds of all varieties, but they also create stiffer headwinds for credit assets in terms of cost of capital considerations and refinancing risks. And while the inverted curve in the United States could reward carry-focused investors preferring to stay short in duration, it also portends real risks to economic growth. It is true that we see the risk environment improving for risk and growth-oriented assets, which would include corporate bonds and other credit sectors. However, credit spreads are not exceptionally generous and place a fairly low ceiling on upside potential. By contrast, equities — though more volatile — look like a better place to take on risk exposure in our view.

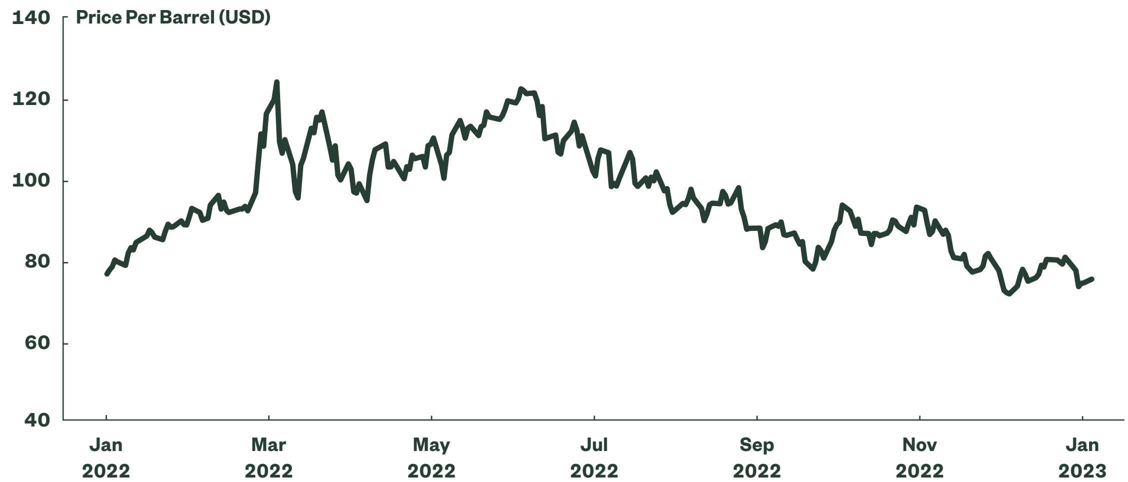
Commodity Markets: Tight Supply and Fragile Demand

One area that may also benefit from the normalization in investors' risk appetite is commodity markets. At first glance there might not be that much support for the asset class, whose historical performance has been associated with periods of economic expansion, at a point in time when we appear to be moving towards one of the most telegraphed slowdowns or recessions in post-war history. While we certainly can't ignore the risks that a global recession and weaker demand could have on commodity prices, an examination of the supply-side dynamics of key sectors gives us reasons for more optimism in our near-term outlook.

Starting with energy, fundamentals remain skewed to the upside and are structurally bullish. Oil inventories continue to decline, global demand continues to run ahead of forecasts, and spare capacity continues to limit supply. While this backdrop may continue to fuel volatility in the oil market, short-term weakness may also provide an attractive buying point at current levels.

Figure 8
Crude Oil Price Retreat

West Texas Intermediate Crude Oil



Source: Federal Reserve Bank of St. Louis. Past performance is not a reliable indicator of future performance.

Industrial metals prices benefit from similar supply-side tailwinds as tight energy supply tends to support prices by limiting production. Furthermore, tight inventories for copper, aluminum, and zinc make them susceptible to any surprise pickup in demand as the London Metal Exchange will enter 2023 with the smallest available warehouse of stockpiles in the last 25 years. While demand for metals has held up so far, it is likely to deteriorate as global economic activity continues to slow, as hinted by recent global PMI figures, causing us to moderate our outlook for base metals in general.

Credible Conclusions

As we progress into 2023, the tug of war between risks and opportunities will inevitably ebb and flow, but our underlying view is that a healing process will eventually emerge as inflation, the most prominent macroeconomic risk, gradually recedes. At this point it may be worth reviewing how the FOMC weighed some of the very same trade-offs when they were on the verge of squeezing inflation out of the macroeconomic system and microeconomic psyche in 1982. The following passage is from Fed Chair Paul Volcker when he was describing his thoughts on moving away from some of the extraordinary policy measures then in use:

"Most people in the financial markets at least, to put it bluntly, think we've overstayed the course now. It gets into this great question of credibility that I suppose we're taking rather personally. At the risk of being misunderstood, following a mechanical operation because we think that's vital to credibility and driving the economy into the ground isn't exactly my version of how to maintain credibility over time." [3]

The healing process we envision will invariably encounter obstacles in the coming year. And our current, budding, optimism may have to be recalibrated. But we think policymakers today will come to a similar conclusion as Volcker did in the early 1980s — that driving the economy into the ground, even in the name of inflation, will do little to promote credibility.

Sources: Bloomberg, FactSet, J.P. Morgan, Barclays, MSCI, Morgan Stanley and The Economist as of December 30, 2022.

Endnotes

1 *Continuity, consistency and credibility.* Introductory remarks by Mario Draghi, President of the ECB, at the 21st Frankfurt European Banking Congress "The Big Shift", Frankfurt am Main, 18 November 2011.

2 Using the Bloomberg Global Treasury Index as of 12/30/2022.

3 FOMC Transcript (October 5, 1982, p. 50) referenced from: Kliesen, Kevin L. and David C. Wheelock. *Managing a New Policy Framework: Paul Volcker, the St. Louis Fed, and the 1979-82 War on Inflation.* Federal Reserve Bank of St. Louis Review, First Quarter 2021, 103(1), pp. 88.

State Street Global Advisors Forecasts as of 31 December 2022

	2022 (%)	2023 (%)
Real GDP Growth		
Global	2.9	2.3
US	1.9	0.4
Australia	3.7	2.1
Canada	3.3	0.5
Eurozone	3.3	0.3
France	2.6	1.0
Germany	1.8	-0.1
Italy	3.8	0.3
UK	4.4	-0.7
Japan	1.2	1.5
Brazil	3.5	1.4
China	3.5	5.0
India	7.3	6.0
Mexico	3.0	1.5
South Africa	2.2	1.5
South Korea	2.7	1.4
Taiwan	2.7	1.3
Inflation		
Developed Economies	8.1	4.6
US	8.0	3.6
Australia	6.6	4.2
Canada	6.8	3.5
Eurozone	8.4	5.5
France	5.3	4.2
Germany	8.4	5.5
Italy	8.2	5.9
UK	9.1	6.8
Japan	2.5	2.4
China	2.0	2.2

	30 December 2022 (%)	31 December 2023 (%)
Central Bank Rates		
US (upper bound)	4.50	4.50
Australia	3.10	3.85
Canada	4.25	4.50
Euro	2.50	3.25
UK	3.50	4.25
Japan	-0.10	-0.10
Brazil	13.75	11.50
China	4.35	4.35
India	6.25	6.25
Mexico	10.50	10.00
South Africa	7.00	7.00
South Korea	3.25	3.25
10-Year Bond Yields		
US	3.88	4.02
Australia	4.05	4.51
Canada	3.30	3.37
Germany	2.53	3.00
UK	3.66	4.05
Japan	0.42	0.45
Exchange Rates		
Australian Dollar (A$/$)	0.68	0.77
British Pound (£/$)	1.20	1.32
Canadian Dollar ($/C$)	1.35	1.23
Euro (€/$)	1.07	1.14
Japanese Yen ($/¥)	131.95	115.00
Swiss Franc ($/SFr)	0.93	1.00
Chinese Yuan ($/¥)	6.95	6.50

One-Year Return Forecasts	USD (%)	EUR (%)	GBP (%)	JPY (%)	AUD (%)	CAD (%)
S&P 500	5.9	-0.9	-3.5	-7.7	-6.7	-3.9
Russell 2000	6.9	0.1	-2.6	-6.8	-5.9	-3.0
MSCI EAFE	7.4	0.5	-2.1	-6.4	-5.4	-2.5
MSCI EM	7.2	0.4	-2.3	-6.6	-5.6	-2.7
Barclays Capital Aggregate Bond Index	4.0	-2.6	-5.2	-9.4	-8.4	-5.6
Citigroup World Government Bond Index	2.6	-3.9	-6.5	-10.6	-9.6	-6.9
Goldman Sachs Commodities Index	4.0	-2.6	-5.2	-9.4	-8.4	-5.6
Dow Jones US Select REIT Index	6.0	-0.8	-3.4	-7.6	-6.6	-3.8

State Street Global Advisors Forecasts, as of 31 December 2022.
The above estimates based on certain assumptions and analysis made by State Street Global Advisors. There is no guarantee that the estimates will be achieved.

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- Build from breadth
- Invest as stewards
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* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of September 30, 2022 and includes approximately $55.12 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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Information Classification: General

Marketing communication

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