Perspectives – Long view (edition 02/2023)

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Central banks have not yet reached their goal

Dr. Jürgen Michels, Chief Economist and Head of Research, BayernLB

According to the customary definitions, major Western central banks have pushed their key rates up into restrictive territory, and peak inflation is now behind us. It is logical therefore that monetary policymakers will now move to downshift their rate-hiking pace and will adopt a more data-driven stance. For investors, the question hanging over the forthcoming central-bank meetings is not going to be “How high will the next rate hike be?” but rather “Is there going to be a further rate hike?”

Even though the ECB has already provided an uncommon amount of clarity by pre-announcing a further 50bp policy rate hike for their March get-together, the meeting will prove a highly exciting affair nevertheless. This is because ideas about the way forward appear to be diverging sharply in the wake of a phase of marked consensus within the Governing Council. The debate will be based on the new set of staff macroeconomic projections, but also on a decidedly mixed bag of data, ranging from receding inflation rates to economic indicators with conflicting signals to robust labour markets marked by mounting wage pressure. As the latest example - the January German inflation print - demonstrates, data quality is not very good. We are therefore expecting the ECB to consider further rate hikes to be necessary in March. We are accordingly raising our interest-rate forecast, and now see an additional step coming through in May, taking the deposit facility rate up to 3.25%.

The Fed has already slowed the pace of its rate hikes. Given the ongoing boom in the US labour market and stubbornly elevated inflation rates in the services sphere, Team Powell will likely remain on its tightening path, in the first instance, in spite of increasing signs of a cooling economy. We are therefore upping our forecast here too, now envisioning an additional rate hike in May, which would put the upper boundary of the target range at 5.25%.

Financial-market volatility will probably rise in tandem with the central banks‘ data fixation. Investors will be asking themselves whether each new data point, especially out of the USA, will lead to a further rate hike which might bring the economy down for a hard landing. Despite some outliers among incoming data, we think it should be clearly recognisable by May that the rate hikes implemented to date will trigger an economic slowdown (and a more full-blown recession in Europe) and that no further rate moves are required. At the same time, hopes of swift rate cuts are going to vanish. Yield-curve inversion should accordingly accompany us for a long time to come, but ought to bottom soon.

Yours very sincerely, Jürgen Michels

Clear & concise

- Inflation rates have peaked in both the United States and Europe;
- We are expecting a minor growth bump in the USA and a recession in Europe;
- Central banks will slow their tightening pace, with key policy rates poised to peak during the second quarter of the present year;
- Yield curves on both sides of the Atlantic will remain inverted for a longer period.

Global environment: Torn this way and that

▶ Inflation pressure is receding amid mixed news from the economic-growth front

The latest incoming economic data have run a wide gamut, ranging from decidedly strong US labour-market numbers to persistently poor production readings out of Europe. Mixed reports will, in all probability, remain the name of the game over the coming months. With support forthcoming from the phasing-out of coronavirus-related restrictions, a pick-up in economic activity in China is poised to further unwind supply-chain snarls. On the downside, however, purchasing-power losses and the pass-through of monetary-tightening measures will put a brake on economic growth, in Europe in particular, presumably provoking a recession.

Pleasing news is to be reported regarding inflation, which has peaked in many places. In view of the robust state of the labour market and of the corresponding threat of wage-price spirals, both the Federal Reserve and the ECB will, in all likelihood, extend their rate-hiking cycles until May, although the pace of rate hikes should slow. What is more, rate cuts in the new cycle are probably no longer on the agenda for as early as 2023, even in the case of the Fed.

Commodity markets: Scarce reserve capacities – recovery potential for the oil price

▶ The sanctions imposed on Russia are by now biting harder

We continue to envisage the barrel price of Brent crude at USD 90 on a three-month view and at USD 95 in six months' time. The price of crude is being lent support by the economic rebound and by resurgent demand for oil in China. What is more, the USA is now only likely to witness a cyclical cooldown, rather than an outright slump, over the course of the coming months. Last but not least, Western sanctions against Russia are increasingly reducing the Russian oil supply: the Russian Federation is aiming to pump up approximately 5% less oil from March onwards, which ought to underpin the world-market price. On a twelve-month horizon, by contrast, we now see oil quotations stagnating in the vicinity of USD 95 (previous estimate: USD 100). It is our expectation that the projected slowdown in US economic activity will, by then, have entailed a distinct rise in the unemployment rate stateside and a correspondingly higher degree of risk aversion on financial markets. Oil prices customarily react relatively sensitively to such shifts, our inference thus being that a further northward push in the oil price will only be on the cards when it has become clear that the US economy is back in recovery mode. At that point, the scarce reserve capacities on the oil market are likely to move back into focus to a greater extent.

▶ Although on a downward path, we see gold prices continuing to be supported by central-bank buying

In the case of gold, we continue to assume that the yellow metal will suffer a price setback on a three-month view before staging a recovery on a twelve-month horizon. Now that gold quotations, like in previous years, have not managed to hang on to the higher ground to the north of the USD 1,900-per-ounce mark, further key-rate increases from the Fed will probably depress prices somewhat further during the months ahead. However, once Fed rate cuts move closer twelve months from now on the back of a rise in the US unemployment rate, gold ought to once again set sail on an upward trajectory towards USD 1,900. In this context, we conjecture that central banks, above all from threshold countries, will continue to engage in "buy the dip" transactions during phases when the yellow metal is showing weakness, the aim being to diversify their reserve mix through gold purchases so that they cannot become subject to Western sanctions as easily as in the case of Russian foreign-currency reserves.

USA: Flying high instead of coming down to a soft landing

▶ Obstinate inflationary pressure will probably translate into a higher terminal fed funds rate

The US economy has got off to a buoyant start in the new year. It is true that macroeconomic growth stateside is gradually waning in the wake of the vigorous expansion observed in the fourth quarter, yet the upward ratchet in interest rates continues to be shrugged off by the local labour market as though it were just water off a duck's back. After all, the US unemployment rate declined to a historic low of 3.4% in January and job growth accelerated. At the same time, though, the downward trend in inflation faltered. Stubbornly elevated wage and overall-inflation momentum remains a thorn in the Fed's flesh, and we are accordingly looking, following a rate hike in March, for an additional upward tweak to the federal funds target range in May, putting the terminal ("peak") rate at 5% - 5.25%.

- We do not see any key-rate cuts being implemented during the present year

Although aggregate economic output across the USA looks set to expand again in the first quarter of 2023, we continue to anticipate a mild recession over the course of the year. The more restrictive interest-rate level will take its toll on the labour market too over the coming months. The US manufacturing and construction sectors are already flashing recession signals. With the spectre of stubborn inflation liable to strut the stage for longer, the Fed will presumably only pivot to rate cuts during the coming year, with such cuts, moreover, coming through only slowly.

Euro area: Inflation is on the retreat

- We have nudged down our 2023 inflation forecast, but still see the ECB implementing a minor policy rate hike in May

January's consumer-price-inflation numbers were certainly an event which made market observers sit up and take notice: even though Eurostat's flash estimate (an annual rate of 8.5%, down from 9.2% in December) will, in all likelihood, be revised upwards at the final count, the inflation trend has therefore slowed to a noticeable extent during the past few months. This effect is attributable to lower energy prices, a strong euro and ever more palpable statistical base effects. The update in the weighting structure for the basket of goods and services on the year 2022 - involving a higher weight for services, an item less heavily buffeted by the inflation wave - has likewise helped to put HICP inflation on a lower path. We are lowering our projection for 2023 EMU-wide inflation from 7.1% to 6.5%. In the medium term, the euro area inflation rate ought, from late 2024 onwards, to once again approach the ECB's target, yet deflation risks are now a thing of the past in view of the shortage of workers (of skilled labour, in particular) and of the costs of decarbonisation. That said, the decline in inflation is likely to have brought less relief to the ECB's rate-setting committee than is being commonly assumed: both economic-growth and labour-market parameters have recently been springing too many positive surprises for that. In accordance with this, upside wage pressure remains high. We are expecting Team Lagarde to decide on a further policy rate hike of 25 basis points in May, and see the terminal rate for the deposit facility rate at 3.25%.

Germany: More and more signs of a recession emerging in the 22/23 winter half year

- The "hard" production data are not yet confirming the slew of positive survey outcomes

Even though leading indicators have been sketching a less gloomy picture of late, and although the Composite PMI for Germany already found itself back knocking on the door of the 50-point mark separating expansion from contraction in February, many factors imply - following the downward revision to the real GDP reading for Q4 2022 (now -0.2% quarter-on-quarter) and the more-than-sluggish "hard" data on industrial output for December - that GDP in the Federal Republic is on course to decline in Q1 2023. Not the least important drags here are the anaemic consumption climate and a persistently underwhelming order intake. At least inflation took a major downward leap in January, even though the downhill trajectory has been heavily distorted by state intervention measures. Parallel to our projection for the euro area as a whole, we are significantly lowering our estimate for 2023 German inflation from 7.9% to 6.8%. Nonetheless, inflation looks like remaining a stubborn foe, destined to still be higher than the ECB's target variable in 2024. One piece of evidence on this score is the robust labour-market trend.

- In the euro's case, upside pressure on inflation and pressure for higher key rates is going to endure for longer

Foreign-exchange markets: The dollar is heading downhill with the handbrake on

We are continuing to adhere to our forecast for the dollar-euro pair, seeing the greenback gradually losing traction to above USD/EUR 1.10 in six months' time and to USD/EUR 1.12 twelve months out. Since January's surprisingly strong US labour-market data, the market has been attaching greater weight to the risk scenario involving heavier wage and core-inflation pressure, impelling the Fed to push the fed funds rate up to a more marked extent than had been previously priced in. This has caused the dollar to appreciate to some extent. However, we are assuming that these developments will reverse again in response to an inflation-dampening cooldown in economic activity over the coming months. Twelve months from now, such a growth slowdown will, in all probability, be entailing a rise in the unemployment rate and correspondingly higher risk aversion on the markets, which ought to buttress the dollar thanks to "safe haven" flows. At the same time, however, the Fed's initial key-rate cuts in the new cycle (2024) will presumably be drawing closer as a result, leading us, all things considered, to expect further slow dollar depreciation relative to the single currency, an additional reason being that ECB policy-rate cuts ought not to be foreseeable yet by that point.

Bond markets: Pronounced yield-curve inversion

- Government bonds: We have made a marginal upward revision to our yield forecasts

Once again upwardly mobile key-rate expectations in the USA and the euro area have send both Treasury and Bund yields higher of late, causing yield curves to invert to a more pronounced extent. Key-rate bets which had previously been excessively optimistic, above all in the USA, now appear to have corrected sufficiently, however, although there remains a risk of central banks pushing key rates even deeper into restrictive territory in the event of high inflation prints continuing to prove surprisingly persistent. In the light of our revised key-rate projections for both the Fed and the ECB, we have made marginal upward corrections to our yield forecasts, but are nonetheless looking for yields to be on a slightly lower trajectory in twelve months' time than they are today. Yield curves on both sides of the Atlantic ought to become less inverted in the process.

- Covered bonds: The ECB is withdrawing from the covered-bond segment

Although currently widening further, covered-bond spreads ought to stabilise soon. Pressure on spreads is deriving from the ECB, whose balance-sheet-reduction plans mean that it is withdrawing further from the market. At the same time, the volume of new issues is poised to remain high for the time being. Given that the ECB telegraphed its QT plans at an early date, part of their impact has presumably been factored in already. What is more, there should be a greater level of support for the sector from total-return investors going forward. After all, the now higher yield level offered by covereds is making this asset class more attractive (the average yield on 10-year Mortgage Pfandbriefe is 3.1% at present). In addition, the stabilising interest-rate environment will, in all likelihood, have positive repercussions on spreads.

- Corporate bonds: ECB balance-sheet roll-off is looming ahead

Corporate spreads continue to look stable, unfazed by the heavy volatility affecting the government-bond market. Although most of the supply-side participants jostling in the primary market continue to be investment-grade issuers, there have also been a certain number of high-yield or hybrid bond launches. To date, the market has been absorbing the fresh supply with apparent ease. However, spreads will probably come under mild pressure when the ECB embarks on balance-sheet roll-off in March.

- Bank bonds: The tailwind for bank bonds appears to be dying down in the short term

Primary-market activity in the unsecured-bank-bonds domain has normalised again after the records set in January. In the secondary market, sentiment has been highly positive over the past few weeks, yet the wind appears to be turning at this very moment. Even though the reporting season has, by and large, proved solid, one or two negative surprises have been sprung on the cost front (risk-management and administrative costs). Investors would be well advised to take off any rose-tinted spectacles at the present juncture, and should brace for gentle spread widening in the short term. Outperformance relative to non-financials only looks like regaining momentum around the middle of the year.

Equity markets: A limited spell of consolidation

- Bullish momentum is taking a pause, but will presumably regain pace when the next dividend season arrives

The initial spurt of equity-market performance on the cards for 2023 has already predominantly run its course: resurgent inflation and rate-hike expectations, fuelled by favourable incoming economic data since the beginning of February, and overbought market-based indicators are, for the time being, keeping the bullish momentum which has been in evidence since the outset of the year in check. Yet the risk-on rally has headroom to continue, provided that the trend towards receding inflation remains in place, that macrogrowth remains solid and/or that a soft landing remains probable. In the event of inflation remaining relatively firmly anchored at the high end of the Fed's scale at around 2.5%, and of long-term US Treasury yields staying well south of last year's annual highs, stock-market bulls should feel their momentum rekindling again in Q2 when the dividend season comes around, before the upper boundary of the current sideways market is reached. In this context, the revival of the value segment, and the rotation away from US stocks towards European and EM equities which we have been observing since last October, ought to continue.

Economic forecasts

In Percent

	% of world GDP	Gross Domestic Product change on previous year in percent			Inflation change on previous year in percent			Budget Balance in percent of GDP			Gross Public Debt in percent of GDP			Current Account Balance in percent of GDP		
		2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024	2022	2023	2024
USA	24.6	2.0	0.7 (0.4)	2.2	8.0	4.5	3.2	-5.0	-4.2	-4.5	122	120	121	-3.2	-2.8	-3.0
Euro area	15.5	3.5	-0.4	1.6	8.4	6.5 (7.1)	3.6	-3.8	-4.1	-3.7	94	92	91	1.5	1.9	2.4
Germany	4.6	1.8	-0.9	2.0	7.9	6.8 (7.9)	3.3	-2.6	-3.1	-3.0	67	66	64	2.8	3.7	5.0
France	3.2	2.6	-0.2	1.7	5.9	5.6 (6.0)	3.7	-4.9	-5.0	-4.5	112	111	110	-2.5	-1.3	-0.8
Italy	2.2	3.8	-0.3	0.9	8.7	7.7	3.6	-5.1	-4.5	-4.0	145	141	140	0.8	-0.2	0.5
Spain	1.5	5.3	0.3	2.4	8.3	5.5 (6.4)	3.4	-4.6	-4.3	-4.0	114	112	110	0.9	0.8	1.2
Netherlands	1.1	4.3	-0.2	1.9	11.6	7.3 (9.2)	4.2	-1.1	-4.0	-3.1	45	44	44	5.7	5.3	6.9
Japan	5.3	1.3	1.1	1.4	2.5	2.2 (1.8)	1.4 (1.3)	-7.8	-3.6	-2.5	264	261	260	1.6	0.3	0.6
United Kingdom	3.4	4.0	-0.8 (-1.0)	1.0	9.0	7.4	4.0	-6.5	-4.5	-3.8	100	99	100	-5.5	-5.8	-5.0
Canada	2.1	3.2	0.5	2.0	6.8	3.7	3.0	-2.7	-1.2	-0.6	102	99	96	0.5	-0.2	-0.4
South Korea	1.9	2.6	1.8	2.5	5.0	3.2	2.0	-1.8	0.0	0.2	54	55	55	2.8	1.7	2.0
Switzerland	0.9	2.0	0.0	1.4	2.8	2.4 (2.2)	1.5	-0.3	0.2	0.7	26	25	24	8.2	8.5	8.5
Other Advanced Economies	3.6	2.9	1.2 (1.4)	2.6 (2.4)	7.3	6.1	2.5	-3.5	-3.0	-2.3	55	51	48	3.9	1.8	1.5
Advanced Economies	57.3	2.6	0.4 (0.3)	1.9	7.4	5.0 (5.1)	3.1	-4.7	-3.7	-3.5	117	115	115	-0.7	-0.7	-0.6
China	18.9	3.0	5.2	5.5	2.0	2.2	2.4	-8.8	-7.0	-7.0	77	83	87	2.4	1.3	1.0
Asia (w/o. CN / JP / KO)	8.4	5.4	4.4 (4.5)	5.1	5.6	4.8 (5.1)	4.4 (4.5)	-	-	-	-	-	-	-	-	-
India	3.4	7.0	5.7	6.0	6.7	5.1 (5.5)	5.3 (5.0)	-10.0	-9.0	-8.5	84	84	84	-3.6	-2.5	-2.5
Indonesia	1.3	5.2	4.5	5.0	4.2	4.1 (4.3)	3.4 (3.5)	-4.0	-3.0	-3.0	41	41	41	0.8	-0.5	-1.6
Latin America	4.7	3.6	1.0	1.9	9.7	6.6 (6.1)	5.3 (5.0)	-	-	-	-	-	-	-	-	-
Brazil	1.7	3.0	1.0	1.8	9.3	5.4 (4.8)	4.5 (4.0)	-4.6	-8.0	-8.0	86	89	91	-2.8	-2.5	-2.0
Mexico	1.4	2.8	1.5	2.0	7.9	5.8 (5.5)	4.0	-3.7	-4.0	-2.6	57	59	59	-1.2	-1.2	-1.1
Russia	1.9	-4.0	-4.0	1.5	14.0	6.0	5.0	-2.5	-3.5	-1.0	17	19	19	11.0	1.5	2.0
Central/Eastern Europe	3.2	1.1	1.9 (2.1)	3.5 (3.7)	30.1	21.7	9.3	-	-	-	-	-	-	-	-	-
Turkey	0.9	5.0	2.0 (1.8)	2.5 (2.0)	73.0	42.0	20.0	-4.3	-5.5	-6.0	38	38	40	-5.5	-4.5	-4.0
Poland	0.7	4.9	0.8	2.9	13.2	12.8	5.5	-4.8	-5.5	-5.2	51	53	54	-3.5	-2.8	-1.6
Middle East, North Africa	4.3	4.8	3.1	3.7	13.8	11.0	8.0	-	-	-	-	-	-	-	-	-
Sub-Sahara Africa	1.3	3.0	2.7	3.1	14.4	12.0	9.0	-	-	-	-	-	-	-	-	-
South Africa	0.4	2.0	1.5	1.8	6.7	5.3	4.7	-5.0	-5.5	-6.1	68	71	74	1.3	-1.0	-1.4
Developing Countries	42.7	3.3	3.6 (3.7)	4.4 (4.5)	7.7	6.0	4.5	-6.1	-5.4	-5.4	65	68	70	1.3	1.0	0.6
World	100.0	2.9	1.8	3.0	7.5	5.4 (5.5)	3.7	-	-	-	-	-	-	-	-	-

Sources: Refinitiv, BayernLB Research "-" not available old forecasts in parenthesis

Interest rates and yield forecasts

Interest rates and yields in percent, spreads in basis points, end of month

		actual 21.02.2023	in 3 months May 2023	in 6 months Aug 2023	in 12 months Feb 2024
Key interest rates					
Euro area*		2.50	3.25	3.25	3.25
USA		4.50 - 4.75	5.00 - 5.25	5.00 - 5.25	5.00 - 5.25
Japan*		-0.10	-0.10	-0.10	-0.10
United Kingdom		4.00	4.50	4.50	4.50
Switzerland*		1.00	1.50	1.50	1.50
Yield curves					
Germany / Euro area	3M EURIBOR	2.68	3.35	3.30	3.30
	2 years	2.95	2.80	2.60	2.35
	5 years	2.60	2.45	2.35	2.25
	10 years	2.54	2.40	2.30	2.25
	30 years	2.47	2.30	2.30	2.30
EUR Swap rate	10 years	3.09	2.90	2.80	2.75
USA	3M SOFR OIS	4.84	5.25	5.20	5.15
	2 years	4.74	4.60	4.30	3.90
	5 years	4.18	4.00	3.80	3.65
	10 years	3.98	3.80	3.65	3.50
	30 years	3.98	3.85	3.75	3.70
Japan	3M JPY OIS	-0.01	0.00	0.00	0.00
	10 years	0.51	0.50	0.50	0.50
United Kingdom	3M SONIA OIS	4.13	4.30	4.55	4.50
	10 years	3.62	3.50	3.50	3.40
Yield spreads					
Bunds	10 years - 2 years	-41	-40	-30	-10
Treasuries	10 years - 2 years	-76	-80	-65	-40
Treasuries vs. Bunds	2 years	179	180	170	155
	10 years	144	140	135	125
Corporate credit spreads					
iBoxx € Non-Financials	Ø 5.9 years	72	80	80	75
iBoxx EUR Banks Sen. Preferred	Ø 3.6 years	67	75	65	65
iBoxx EUR Banks Sen. Bail-in	Ø 4.5 years	102	110	100	100
iTraxx Europe Main	5 years	80	70	70	70
Covered bonds					
iBoxx € Covered (spread)	Ø 5.2 years	20	24	23	20
Pfandbriefe (yield)	2 years	3.57	3.30	3.10	2.85
	5 years	3.30	3.12	3.02	2.92
	10 years	3.25	3.08	2.98	2.93

Sources: Bloomberg, Refinitiv, BayernLB Research   * deposit rate

Equity markets, exchange rates and commodities

		actual 21.02.2023	in 3 months May 2023	in 6 months Aug 2023	in 12 months Feb 2024
Equity markets forecasts[1)]					
DAX		15,398	15,800	15,700	15,500
EURO STOXX 50		4,250	4,250	4,170	4,100
S&P 500		3,997	4,160	4,120	4,100
Nikkei 225		27,473	28,000	27,800	27,500
Exchange rate forecasts					
Dollar	USD per EUR	1.07	1.08	1.10	1.12
Yen	JPY per EUR	144	141	142	141
	JPY per USD	135	131	129	126
British pound	GBP per EUR	0.88	0.89	0.89	0.90
	USD per GBP	1.21	1.21	1.24	1.24
Swiss franc	CHF per EUR	0.99	1.00	1.02	1.00
	CHF per USD	0.93	0.93	0.93	0.89
Commodities forecasts					
Brent (Dollar per barrel)		83	90	95	95
Gold (Dollar per ounce)		1,836	1,800	1,850	1,900

Sources: Bloomberg, Refinitiv, BayernLB Research 1) end of month

5-Year Forecasts: Charting the course after the epochal shift and the interest-rate turnaround

▶ The “Four Ds” are going to prove decisive in determining the medium-term outlook

We are largely reaffirming our baseline scenario from summer 2022 regarding the medium-term outlook for economic growth, inflation and the financial-market trend. Where mounting investment in **D**igitalisation and **D**ecarbonisation will probably help to revive economic activity on a global basis once the inflation and interest-rate shock has been absorbed, we are expecting the trend towards **D**eglobalisation and the process of **D**emographic change to flatten economic growth, above all in Europe. In addition, medium-term prospects continue to be fraught with an unusual degree of uncertainty on account of the geopolitical risks swirling around.

Structurally weaker economic growth in the medium term

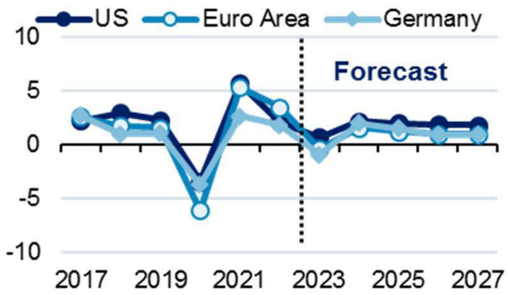
▶ Europe is facing high investment requirements

On a global scale, attaining the targeted climate-protection goals is going to play a more prominent role on the investment-activity front over the coming years. Since Russia will presumably not be acting as a commodity supplier for a longer period of time to come, Europe will, in additional, need to invest to a significant extent in energy security. On top of this, there is a need to catch up in the digital-infrastructure stakes. With support forthcoming from the NextGenerationEU programme, this could lead to an acceleration in investment activity across the European continent. Yet implementation of measures will probably prove to be halting on account of often protracted approval procedures and of a shortfall of capacities in the construction sector. Without a reform of the electricity-price mechanism, it is to be expected that climbing energy prices may well have a dampening effect on capital spending in other domains as well as on private-consumption expenditure.

▶ Deglobalisation and the demographic shift are going to put a damper on growth

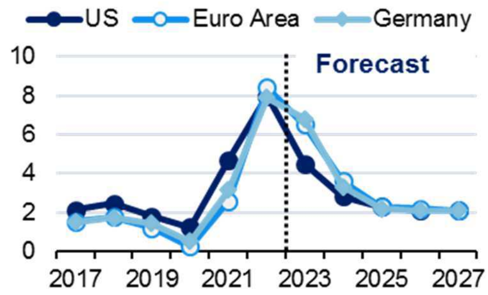
As we recently established in a joint paper with Prognos, the trend towards deglobalisation is set to continue in the crossfire of persistent geopolitical conflicts. Productivity gains and global GDP growth will, in all likelihood, decrease in the medium term in response to the waning momentum of global trade in goods, but also due to the negative knock-on effects on innovative capability which are to be expected. Even though rising expenditure on national security will undoubtedly spur global demand, the resulting stimuli for productivity are likely to be merely limited. What is more, the retirement of the Baby Boomer generation ought to cause the working population to shrink in many Western countries as well as in China over the coming years, an effect which cannot be made up for by a growing workforce in a large number of emerging-market nations. There is therefore much evidence to suggest that the trend growth rate of the world economy, especially in the USA and Europe, is set to move onto a lower trajectory than in past decades.

Lower trend growth
Real GDP growth, percentage change year-on-year



Sources: Refinitiv, BayernLB Research

Inflation rates are on the retreat
Consumer-price inflation, percentage change year-on-year



Sources: Refinitiv, BayernLB Research

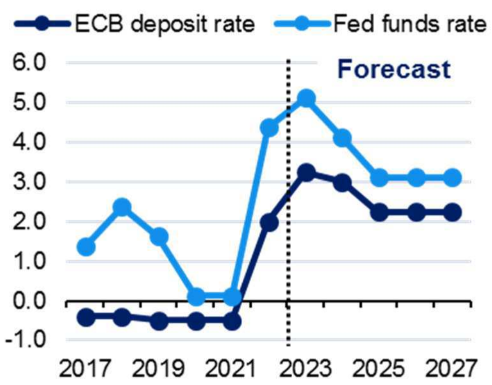
Once the interest-rate turnaround has been digested, a cyclical recovery will beckon

▶ Central banks are resolved to tamp down inflation and will succeed in this quest

The way forward, especially during the first part of the forecast period, will be determined by these structural factors but also, to a decisive extent, by the repercussions of the pronounced monetary tightening which has been induced by rampant inflation. We are assuming that major Western central banks will only end their current rate-hiking cycles when clear signals are coming through that underlying inflation pressure is abating. Given, however, that this will presumably presuppose a distinct weakening of macroeconomic demand, we are projecting a noticeable cyclical slowdown for the present year which, in Germany's case, will see the economy actually slipping into recession. True, such cooling demand will probably reduce the risk of a price-wage spiral. The trend towards declining inflation rates is set to continue, enabling key-rate cuts from 2024 onward, which should then have the effect of boosting economic activity.

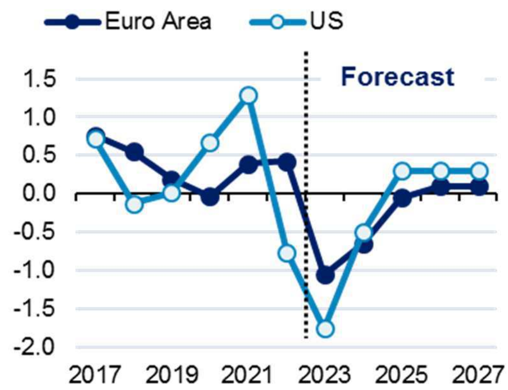
That said, underlying inflation pressure is likely to remain elevated on account of the structural changes sketched out above. Even if central banks take cognizance of this, we do not expect their inflation targets to be significantly raised either formally or in de facto terms. As a consequence the Fed's benchmark key rate (federal funds rate) ought to settle at somewhat above 3% and the ECB's deposit facility rate at somewhere in excess of 2%.

ECB and Fed: On the way to a "new normal"
Federal funds target rate and ECB deposit rate in %



Sources: Refinitiv, BayernLB Research

Yield curves will remain flat after the phase of yield-curve inversion is over
USA and euro area. 3M/10Y spread in %



Sources: Refinitiv, BayernLB Research

A challenging financial-market environment

▶ Trading in fixed-income markets is poised to remain choppy even after yields have peaked out

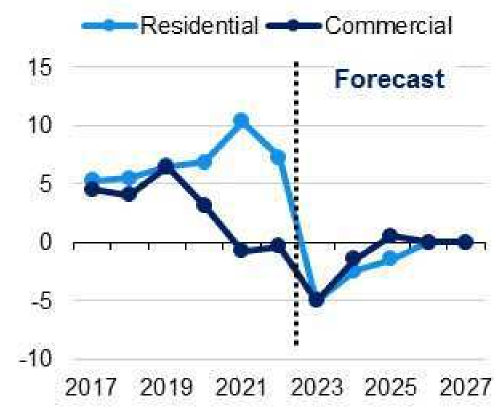
Global fixed-income markets will, in all probability, remain volatile in a macro environment battered by geopolitical uncertainty and in a central-bank environment in the final throes of the rate-tightening process. It is true that the situation should ease to some extent when the new rate-reduction cycle gets underway from 2024 onwards; however, the debt problems encumbering many states, which will simultaneously become more apparent, and the correspondingly high issuing activity connected with this, ought to stand in the way of an appreciable decline in bond-market yields. All the same, we do not envisage that spreads in the euro area will widen to a pronounced extent thanks to the prospect of additional mutualisation measures (following in the footsteps of the NextGenerationEU). In accordance with this, worries about the European Monetary Union breaking apart in the years ahead should remain a minor concern and ought not to constitute a particular burden for the euro's external value. With dollar-euro trading in the direction of USD/EUR 1.30, we expect the USD/EUR currency pair to approach its purchasing-power-parity exchange rate.

In the aftermath of the decidedly dramatic losses which they sustained over the course of 2022, higher-risk assets look like initially logging considerable price gains. In the teeth of a rising number of insolvencies, and despite the disappearance of support from the ECB, spreads on covered bonds and corporates should at least stabilise, with the total-return performance benefiting from the projected marginal decline in risk-free rates of return. In the equity segment, gains are likely to prove moderate in the years following the 2023 upward rebound. By comparison to previous decades, a less accommodative monetary-policy alignment and mounting margin pressure will, in all likelihood, have a less advantageous effect on this asset class. On the other hand, it is our assumption that the, by now, more or less "traditional" market reactions over the US election cycle will come into play, with positive stimuli for global stock markets being imparted by the 2026 midterm elections.

Equities are on a moderate upward trajectory
S&P 500, Euro Stoxx 50 and DAX (in points)

Sources: Refinitiv, BayernLB Research

Real-estate prices are poised to correct
Germany: Residential and commercial real-estate prices, percentage change year-on-year



Sources: Refinitiv, BayernLB Research

A correction lies ahead for the real-estate market

▶ Higher interest rates are taking their toll

Last year's sea change in interest rates caused new-construction activity to slump, and residential-real-estate prices in Germany also corrected at the end of 2022 against a backdrop of extremely low turnover. This notwithstanding - in contrast to commercial-property prices, which were marginally in reverse gear for the second successive year (2022: -0.4%) - residential-real-estate prices surged by an annual average of no less than 7.2% on a nationwide basis in 2022. Even though the robust state of the labour market will probably prevent a flood of firesales, sellers will increasingly be prepared to agree to offers beaten down by the sharp rise in interest rates. Broadly speaking, we are therefore looking for real-estate prices to retrace downwards by 5% in Germany, and are also forecasting a decline in commercial-property prices of the same magnitude for the USA. We foresee an even more pronounced decline of roughly 7½% for the United Kingdom. On the upside, the more interest-rate-sensitive commercial-property domain is likely to gradually recover in the years ahead on the back of the upcoming interest-rate reversal. In the case of German residential real estate, the correction in the existing-home field is likely to drag on for longer even though there continues to be too little new-construction activity. Along with the price markdowns which threaten for buildings whose energy efficiency has not been improved, the fact that mortgage rates are not budging from their higher levels relative to preceding years is likely to put a downward drag on the price trend.

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Economic forecast

Overall economy; in percent

	USA	Euro area	Germany	France	Italy	Spain
GDP (y/y)						
2022	2.1	3.5	1.8	2.6	3.8	5.3
2023	0.7	-0.4	-0.9	-0.2	-0.3	0.3
2024	2.2	1.6	2.0	1.7	0.9	2.4
2025	2.0	1.2	1.5	1.2	0.7	1.5
2026	1.9	1.0	0.9	1.0	0.6	1.5
2027	1.8	1.0	0.9	1.0	0.6	1.5
Inflation (y/y)						
2022	8.0	8.4	7.9	5.9	8.7	8.3
2023	4.5	6.5	6.8	5.6	7.7	5.5
2024	2.8	3.6	3.3	3.7	3.6	3.4
2025	2.3	2.3	2.2	2.2	2.0	2.6
2026	2.1	2.2	2.1	2.1	1.8	2.4
2027	2.1	2.1	2.1	2.1	1.8	2.4
Budget Balance (% of GDP)						
2022	-4.0	-3.8	-2.6	-4.9	-5.1	-4.6
2023	-4.2	-4.1	-3.1	-5.0	-4.5	-4.3
2024	-4.5	-3.7	-3.0	-4.5	-4.0	-4.0
2025	-4.8	-3.5	-3.0	-3.5	-4.0	-3.5
2026	-4.8	-3.5	-3.0	-3.5	-4.0	-3.5
2027	-5.0	-3.5	-3.0	-3.5	-4.0	-3.5
Gross Public Debt (% of GDP)						
2022	120	94	67	112	145	114
2023	122	92	66	111	141	112
2024	123	91	64	110	140	110
2025	124	91	64	110	142	110
2026	126	91	64	111	144	109
2027	127	92	64	111	146	109

Sources: Refinitiv, BayernLB Research

Exchange rate, interest rate and yield forecasts

Interest rate, exchange rate and stock index forecasts; year-end balance

	Key interest rates in %		Yields in %			
	Euro area 1)	USA	Bunds 2y	Bunds 5y	Bunds 10y	Treasuries 10y
2022	2.00	4.375	2.73	2.56	2.56	3.83
2023	3.25	5.125	2.40	2.30	2.25	3.50
2024	3.00	4.125	2.35	2.40	2.40	3.70
2025	2.25	3.125	2.10	2.20	2.25	3.50
2026	2.25	3.125	2.20	2.30	2.40	3.50
2027	2.25	3.125	2.20	2.30	2.40	3.50
	Spreads 2)	**FX rates 3)**	**Stock indices**			**Brent**
	iBoxx Euro Non-Fin	EUR-USD	DAX	EURO STOXX 50	S&P 500	USD/barrel
2022	147	1.05	13,924	3,794	3,840	99
2023	125	1.10	15,500	4,100	4,100	93
2024	120	1.17	16,400	4,200	4,300	105
2025	130	1.25	17,500	4,350	4,500	103
2026	130	1.28	18,025	4,450	4,600	88
2027	130	1.28	20,390	4,760	4,920	80

Sources: Refinitiv, BayernLB Research 1) deposit rate 2) in basis points over bunds 3) yearly averages

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