Helaba

Markets and Trends 2023

Global economy on a ridge walk

Research & Advisory, November/December 2022



Values with impact.

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Editorial date: 15 November 2022

2023: The Editorial



I love mountains. Be it in summer or winter, I enjoy being up above the clouds, surrounded by majestic peaks. Yet, my fascination for these natural wonders is matched by a profound respect for them. From one moment to the next, a crisp sunny day can turn into a treacherous hazard shrouded in mist. While the path was easily discernible a few moments before, suddenly every step turns into a perilous balancing act – all the more so the less predictable the terrain is.

Mountains are not for everyone with their sudden changes in weather, unstable terrain, narrow trails and thin air. Even experienced mountain hikers can break out in a cold sweat when both sides of a slender ridge reveal a yawning abyss below – as is presently the case with the global economy.

Alpine landscape as theme of Helaba's Economic and Capital Market Outlook 2023

Businesses and consumers are losing their footing in the face of record-high energy costs. The fear of a precipitous social plunge is spreading deep into the middle of society. This is compounded by the immediate threat of economic downturn. Governments are walking the tightrope of balancing the need to provide urgent relief to consumers with preserving the competitiveness of their countries and their attractiveness as a location for businesses and investment. The global economy has already begun to stumble. Navigating this narrow ridge with any degree of surefootedness requires carefully targeted monetary and fiscal policy decisions. Any missteps will be immediately punished – as recent events in the UK clearly demonstrate.

Overview of scenarios: Probability of occurence



Source: Helaba Research & Advisory

Outlook with three scenarios

All of this provides the backdrop to our annual outlook for 2023. For the majority of people, the most plausible scenario is currently a **plunge** – a deep recession, to which we attach a relatively high probability this year (30 %). It is hard to imagine that conditions will soon clear up and give way to abundant sunshine, even if sudden changes in the weather are commonplace in mountainous terrain. However, we have only given this scenario, which we have termed a **family hike**, a 10 % likelihood of occurring. We attribute the highest chance of 60 % to our baseline scenario: a **ridge walk**.

Everyone is confronted with geopolitical uncertainty and the energy crisis, in addition to inflation and recession. In our baseline scenario for Germany and the United States, we expect a recession – albeit at different times, with slightly different catalysts and of varying depth. Just like in the mountains, the weather is also a key factor deter-

mining whether economic conditions deteriorate or quickly improve again. Are we heading for a natural gas shortage with its associated harmful effects on the economy or are we sufficiently prepared thanks to reduced demand for heating? New sources of energy, energy saving initiatives and support from economic policy help to avoid an even worse outcome in our baseline scenario. Over the course of 2023, there is a modest improvement in conditions so that the global economy is able to navigate its path without plunging into the abyss.

Sustainability and energy security

Sustainability was an issue that we had attached considerable importance to in our annual outlook for 2022. Where externalities come into play, the role of the state is to intervene in a regulatory capacity. The externality of carbon dioxide emissions had been largely overlooked for too long. But climate change is becoming an increasingly obvious phenomenon, forcing sustainability firmly onto the economic policy and social agendas of many countries.

> *"A person who does not think about what is still far off is sure to have worries close at hand"*
> *Confucius*

Now, with the end of natural gas imports from Russia, sustainable growth is experiencing a temporary setback due to the increased reliance on coal to generate electricity. In the medium term, though, this may well have a silver lining: High prices for fossil fuels will make renewables comparatively cheaper.

Good mountain guides needed to instil trust and reliability

The backpacks of every member of the hiking party contain various ways of achieving sustainable growth and energy security: cutting consumption, boosting energy efficiency and reallocating energy sources. But only time will tell whether these new dependencies are really more viable. Yet, one of the cardinal rules of Alpine mountaineering is the need for a strong collaborative spirit to ensure that nobody plunges off the ledge. Seasoned mountain guides know how to put together a group in order to instil trust and reliability.

Summary table of sustainability and energy security

Given the enormous importance of sustainability and energy security, our Economic and Capital Market Outlook 2023 includes a summary table with a number of useful indicators on the topics of sustainability and energy security for the countries we have analysed.

A ridge walk for structural aspects, too

2023 will present major challenges as the world teeters precariously on a narrow ridge. On the plus side, although our baseline scenario involves taking many risks and, by extension, making considerable efforts, ultimately the world economy will not plunge off the precipice. This calls for a process of constant policy readjustment according to the nature of the path, the state of the hiking group and the prevailing weather conditions. There is no place for ideological sensitivities. What is needed is determined action with a razor-sharp focus. Should circumstances change, decisions will have to be recalibrated. Simply saying "but we have always done it this way" would be extremely dangerous.

> *"Freedom is not the arbitrary power to act at will, but the ability to act rationally."*
> *Rudolf Virchow*

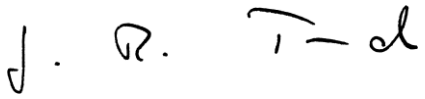
These principles are especially important today since action taken during the Covid-19 crisis had already diverted the hiking group from the path of the market economy and into the unpredictable terrain of interventionist economic policy. There is little regard any longer for excessive borrowing or for the proportionality of measures taken by governments. In many quarters, there are calls to acknowledge the new reality of higher public debt. Surefootedness, that is to say the resilience of an economy, does not increase by accepting rising levels of debt and greater intervention – on the contrary.

Alpine landscape sets the scene

So, join us as we ascend into a mountainous landscape. That is the setting for our Economic and Capital Market Outlook this year, among dark clouds, thin air and big risks along a narrow ridge. But it also holds out the prospect of sunshine, spectacular views, a renewed sense of purpose and relaxation in the great outdoors.

With this in mind, I wish you a sure-footed and successful 2023.

Yours,



Dr. Gertrud R. Traud
Chief Economist / Head of Research & Advisory



Baseline scenario: Global economy on a ridge walk (60 %)

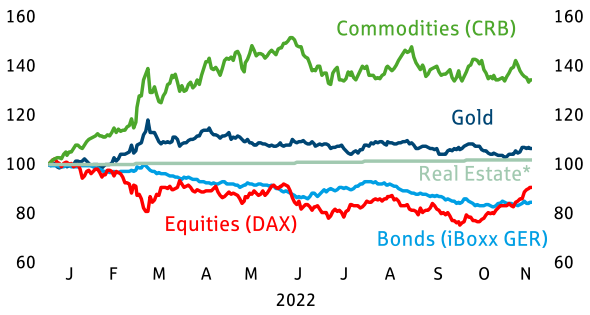
Even seasoned mountain hikers break out in a cold sweat when looking ahead: sheer drops into the yawning abyss stretch out on either side of the narrow ridge along which the global economy is stumbling. At the same time, the hiking group has to make quick decisions based on incomplete information about the further course of the route. The challenges for the "sherpas" in central banks and governments have rarely been as daunting as they are today.

A year ago, the path seemed well mapped out: strong growth as the economy rebounded from the pandemic fuelled by ultra-loose monetary and fiscal policies in addition to the effects of pent-up demand. Higher inflation was largely regarded as a pesky side effect of the recovery rather than a factor that could bring it to an abrupt end. Unfortunately, in late 2022, the situation is radically different in a number of respects.

This is because the global economy veered off this planned route in 2022, a deviation that was not just the result of Russia's invasion of Ukraine and its fallout. This gave already **high inflation** another shot in the arm, particularly in Europe. However, even without the sudden spike in energy and other commodity prices inflation would have been a major problem anyway. Its root cause is an imbalance between supply and demand that has its origins in the pandemic. In turn, inflation prompted central banks, albeit belatedly, to intervene. Meanwhile, they are tightening monetary policy at a pace that was scarcely conceivable only a short time ago. Yet, despite this, they seem to be perpetually "behind the curve".

Commodities gain from the crisis

Total return in euro, indexed to 31 December 2021 = 100



*Helaba Index for German open-ended real estate funds
Sources: Refinitiv, Helaba Research & Advisory

Recession in the baseline scenario

Consequently, the overlapping factors of **Ukraine**, the **energy crisis** and the **fallout from the pandemic** have shaped events in 2022 and prospects for 2023. Far from having disappeared, the latter factor is set to feature prominently in 2023 and not just because of China's “zero-covid”-policy. Global supply chains have not returned to normal yet and changes in consumer behaviour have only partially rectified themselves in many places.

This year, our baseline scenario is **more pessimistic than usual**. For Germany and the United States, we forecast a recession, albeit with different timing, triggers and intensities. Our scenario is based on the assumption that hostilities in Ukraine will continue. Energy prices in Europe will remain high, although new sources of supply will increasingly emerge and efforts to save energy will yield results.

In 2023, the **global economy** will once again grow at a slower pace than in the previous year. This also pertains to most emerging market economies – both commodity-exporting countries and importers. In the case of the global heavyweight, China, we assume that lockdowns will prove less of a drag on the economy and that, accordingly, growth there will be higher than in 2022. The poorest developing countries face **debt crises** that during the pandemic have only been put off by a suspension of debt service repayments by creditors.

Missteps would be very costly

When walking along a mountain ridge, any missteps are usually more consequential than when taking a leisurely stroll through the woods. That is why it is crucial to make the **right political decisions**. Central banks face the challenge of controlling inflation with just the right dose of tightening without triggering an unnecessarily severe recession. That involves correctly gauging the time lags between monetary policy action and its impact on the real

economy and on inflation. Act too slowly and inflation stays high, increasing the risk that it becomes entrenched – as it did in the 1970s. Then the economic costs of reining in inflationary forces too late could be enormous.

At the same time, a **conflict** is looming **between central banks and governments** that are attempting to compensate for the adverse impact of high inflation on real incomes, whether by means of price caps, direct payments or temporarily lower taxes on consumption. If these measures are poorly conceived, they have the potential to create disincentives for saving energy – and thus to indirectly put upward pressure on prices. In addition, the more indiscriminately governments distribute funds to consumers, the more fiscal policy will end up counteracting efforts to tighten monetary policy.

> *"Has [the window for a soft landing] narrowed? Yes! Is it still possible? Yes!"*
> *Fed Chairman Jay Powell, 2 November 2022*

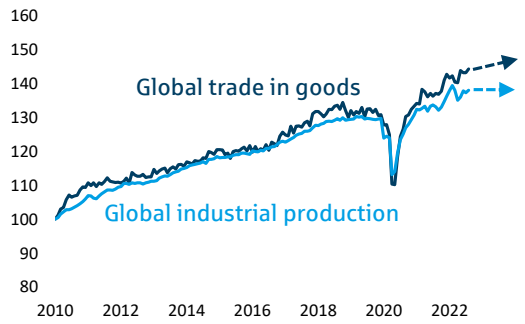
Here, another more recent trend also comes into play: governments reacting to economic shocks with radical interventions in the economy, often with little regard for levels of debt or the proportionality of their responses. The "**nanny state**", which we already saw at work in our 2021 outlook, has gained broad acceptance. Despite a strong economic recovery, attempts to consolidate public finances, which had been heavily stretched during the pandemic, often failed to materialise. In the euro zone, the cyclically adjusted deficit, which ballooned in 2020, only declined marginally in 2021 and 2022. Record levels of debt have seemingly become part of the "new normal" as "More debt!" has become the standard political rallying cry whenever governments are facing unwelcome events.

Will the world inevitably divide into blocs?

The risk of the market economy falling by the wayside on this onward marsh is also very evident in external economic policies. The Ukraine war has driven Russia to turn its economic attention more strongly towards Asia. This reinforces previously discernible tendencies towards the **formation of economic blocs**, with China and the United States at their respective nuclei. China is increasingly perceived as a rival more than as a trading partner, with many concluding that we have to become more like the Chinese if we want to hold our own against them. That has led to calls for an industrial policy or other forms of protectionism – which are likely to do more harm than good.

Boost from global trade

Volumes, indexed to January 2010 = 100



Sources: Macrobond, Helaba Research & Advisory

Rather than a genuine process of "deglobalisation", which remains a risk, we are currently witnessing a **realignment of globalisation**. This is borne out by world trade growing by more than global production since 2020. Although terms such as "reshoring" and "friend-shoring" are prevalent in the media, they are not a factor shaping companies' actions. So far, their focus has remained on efficiency and, to an increasing extent, diversification of supply chains.

Overview of forecasts in our baseline scenario

The major economic blocs – the United States and the euro zone – will experience a recession but still achieve slightly positive average **growth rates** of 0.5 % and 0.2 %, respectively, in 2023. The German economy will shrink. Despite the weak economies, **inflation** will only gradually recede. In Europe, energy shortages will remain a significant factor. Consumer prices will rise by 5.3 % in the euro zone and by 4 % in the United States – more slowly than in 2022 but far above the targets of central banks.

Selected forecasts 2023

Euro area

GDP growth, %	0.2
Inflation, %	5.3

Q1 - Q4			
Refinancing rate, %			
2.75	2.75	2.75	2.75
USD / Euro			
1.05	1.05	1.10	1.10
EURO STOXX 50, index value			
3,850	4,100	4,150	4,200

Germany

GDP growth, %	-0.6
Inflation, %	6.0

Q1 - Q4			
3M Euribor, %			
2.60	2.70	2.70	2.70
10y Bunds, %			
2.30	2.40	2.30	2.30
DAX, index value			
14,000	15,000	15,500	16,000

USA

GDP growth, %	0.5
Inflation, %	4.0

Q1 - Q4			
Federal Funds Rate (mid-point), %			
4.38	4.38	4.38	4.38
10y Treasuries, %			
3.80	3.90	3.80	3.70
S&P 500, index value			
4,250	4,500	4,650	4,800

Source: Helaba Research & Advisory

Central banks will initially push ahead with **monetary policy** tightening, with the Fed only halting its rate hikes in restrictive territory and, despite recession, not lowering rates again in 2023. In contrast, the ECB is likely to act more cautiously. In view of the fragile macroeconomic picture in the euro zone, there will be no scope for further large interest rate hikes.

The storm on the **bond market** is abating. Key interest rates should reach their cyclical peak by the middle of the year at the latest. From experience, this will create headroom for declining bond yields. The yield on 10-year German Bunds will touch highs for the year in the first six months and reach around 2.3 % at the end of 2023.

Refinancing costs for **corporates** will remain high in 2023. That said, essential investments in sustainable business processes and shifting supply chains will lead to greater corporate exposure on the bond market. In terms of earnings, **banks** will be among the winners of rising interest rates and will be able to maintain stable profits, despite cost inflation and growing credit defaults.

As "safe-haven" assets, **covered bonds** will take centre stage. For issuers, obtaining funding with this low-cost product will be more economical than ever, especially if risk premiums between covered and uncovered bonds widen further. Investors will be able to find adequate coupons, even in the core segment.

Equities have already discounted most negative factors. The most important conditions for equity markets to bottom out have been met: cheap valuations, very negative economic expectations, pessimistic investor sentiment and a technically oversold market. As equities lead the real economy by an average of six months, we anticipate a vigorous recovery in prices. By the end of 2023, the DAX should be approaching the 16,000 mark.

Real estate is hit much harder by higher interest rates than by the recession. In the residential market, we expect an end to the protracted boom that will usher in a modest price correction. In the commercial segment, offices will prove more resilient than retail properties, which will struggle in the face of an enormous loss of purchasing power due to high inflation.

Gold will rebound in 2023 as demand for the precious metal as an inflation hedge picks up again. As soon as an end to interest rate hikes is in sight, the gold price will consolidate towards 1,900 US dollar per troy ounce. With a weaker US dollar, it will be virtually impossible to sustain the currency gains of 2022 in euro terms.

The **US dollar** will not be able to resume its upward trajectory as the Fed halts monetary tightening and it will lose some of its appeal as a safe-haven currency. In addition, the dollar is expensive in historical terms and monetary policy in the euro zone will become more restrictive. The EUR/USD exchange rate is likely to be trading at around 1.10 at the end of 2023.

Patrick Franke



Monetary policy: Tightening largely completed

ECB and the Fed are likely to end their cycle of rate hikes in the first quarter of 2023. By that point, their war on inflation may well show a visibly negative effect on the economy.

Christine Lagarde's third year as ECB President has proven a watershed for monetary policy in the euro zone. Confronted with inflation that had spiralled out of control, the central bank initially adopted a hesitant stance before desperately seeking to salvage its battered reputation: it terminated its bond buying programme, left the negative rate territory and raised key interest rates in several sharp moves to around 2 %.

To support its efforts, the ECB created the **TPI** (Transmission Protection Instrument), a monetary policy tool that allows the central bank to flexibly purchase sovereign bonds and, if necessary, control risk premiums in the euro zone. To date, however, the ECB's reinvestments of its vast bond portfolio have sufficed in keeping spreads in the euro zone in line.

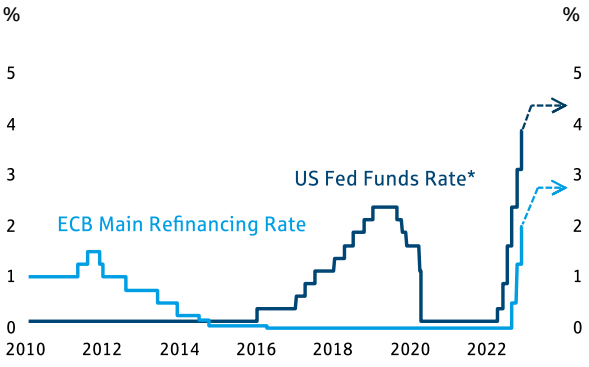
> *"At some point in time, we will have of course to identify the rate which will deliver the 2 % medium-term [inflation] target."*
> *ECB President Christine Lagarde at a press conference on 27 October 2022*

Although monetary policy hawks are currently in the driver's seat, every additional interest rate hike is likely to see a growing resistance from the doves on the ECB's Governing Council. It will not be long before fears about a protracted recession, a crisis in the financial system and stifling interest costs will prompt them to speak up. In our view, a main refinancing rate of 2.75 % will represent a key tipping point. However, the most important prerequisite for any halt to monetary policy tightening will be significant indications that inflation is retreating. After that, the ECB may be able to shore up its tightening course by cautiously reducing its trillion-euro bond portfolio.

Fed: End of the road in sight

In the US, key rates are heading into **restrictive monetary policy territory** at a rapid clip. In the first quarter of 2023, the Fed is likely to stop its rate hiking cycle at a Federal Funds Rate of close to 4.5 % and wait to see the impact of its previous tightening.

Central banks headed for a wait-and-see stance



* middle of the target range
Sources: Refinitiv, Helaba Research & Advisory

Over the last few months, interest rate rises have already resulted in a marked **deterioration of monetary conditions**: lower equity prices, higher long-term interest rates and a stronger dollar. In addition, the passive reduction in the balance sheet of 90 billion US dollar per month will continue for the time being. This will put more downward pressure on growth and inflation. Improvements in supply chain bottlenecks and lower oil prices are helping the Fed. On the US labour market, wage pressures should subside, with weaker economic activity and a modest rise in labour force participation providing relief.

That said, inflation – particularly measured by the core rate – will remain sufficiently high in 2023 that the Fed will **not run the risk of cutting rates**. Fed Chair Powell has stated on many occasions that one of the most important lessons learned from past inflationary episodes is not to relax monetary policy too soon. The mild recession that we forecast for the United States in 2023 will not provide any sufficient justification for this.

%	Q1/23	Q2/23	Q3/23	Q4/23
3M Euribor	2.60	2.70	2.70	2.70
ECB Refinancing Rate	2.75	2.75	2.75	2.75
Fed Funds Target Rate	4.38	4.38	4.38	4.38

Source: Helaba Research & Advisory

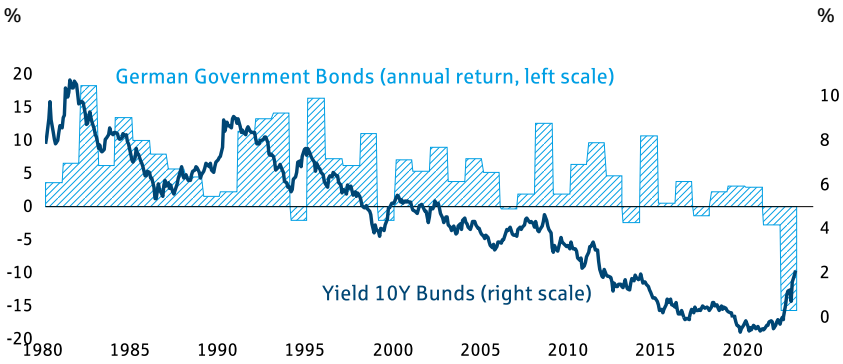
Ulf Krauss, Patrick Franke

Sovereign bonds: Higher interest rates create new risk/reward profile

The once dominant, then long spurned asset class has been breathed new life through the rise in yields. For 2023, there are opportunities, but also a few risks.

For fixed-income investors, 2022 will probably leave them with mixed feelings. While German government bonds **had lost around 15 % of their value** by the end of October, there was a rapid end to the **unfavourable era of negative interest rates**. At times, the yield on 10-year German bunds had risen to as much as 2.5 %. On both sides of the Atlantic, concerns over economic growth and inflation led to severe volatility, with 10-year US Treasuries even breaching the 4-percent mark.

The dawn of a new era – on the bond markets, too



*2022 until end of October
Sources: Refinitiv, Helaba Research & Advisory

Although conditions have significantly worsened for **borrowers**, the situation for **savers** is improving. In particular, large institutional investors such as pension funds and life insurance companies are benefiting from higher interest rate levels. Consequently, new exposures now offer relatively **attractive yields** again. The higher yields rise, the greater investors' appetite will be to buy and this should shield the bond market from any further substantial price erosion.

Stabilisation over course of 2023

Alarmed as it was by record high inflation rates, the ECB embarked on a **historic interest rate turnaround**. By mid-2023, however, the cyclical peak in key interest rates should have been reached and experience shows that this will provide scope for falling capital market rates. That would mean the **yield curve flattening or inverting** in the second half of the year. Despite this, we do not expect any pronounced decline in yields. While inflation is expected to fall, it will remain at historically high levels. In real terms, then, bond prices will continue to be rather unfavourable. On top of that, there is a degree of uncertainty as to what extent the ECB will trim its bond portfolios – after all, more than 40 % of euro area sovereigns in circulation is held by central banks. Any large-scale **reduction in the ECB's balance sheet** would pose new **risks to stability** at a time when government issuance is on the rise.

Risk premiums: The euro area's Achilles' heel?

A sluggish economy, rising government spending and monetary policy tightening sapping liquidity, in conjunction with political blunders, are amplifying the probability of widening **risk premiums**. Indeed, the example of the UK shows how quickly this can happen. Inexperienced governments, such as the new administration in Italy, are under close scrutiny by investors in any case. Yet, even for German bunds, things are not as comfortable as they used to be. As part of its **flexible refinancing operations**, the ECB is more likely to replace maturing Southern European sovereign bonds in its portfolio during critical periods than German ones.

%	Q1/23	Q2/23	Q3/23	Q4/23
10y Bunds	2.30	2.40	2.30	2.30
10y Treasuries	3.80	3.90	3.80	3.70

Source: Helaba Research & Advisory

We forecast the yield on 10-year **German bunds** to stand at **2.3 %** by the end of 2023. Headwinds from the US bond market are expected to decrease, while indications will grow that the US Federal Reserve will adopt a more dovish stance again in 2024. In this case, the yield on 10-year **US Treasuries** is very likely to be trading **below the 4-percent mark** by the end of the year.

Ulf Krauss

Covered Bonds: Demand remains strong

Rising interest rates and the search for high-quality assets will continue to act as a tailwind for covereds in 2023, too. They will remain the funding instrument of choice for banks.

Macro market conditions will prove challenging in 2023, while covered bonds as "safe haven" assets will attract the attention of issuers and investors alike. There are a variety of reasons for this. For banks, obtaining funding via this low-cost product is more economical than ever. Should risk premiums between covered and uncovered bonds (particularly senior preferreds) widen, this advantage could become even more pronounced. That would make the issuance of covered notes significantly more attractive. At the same time, institutions have to consider the extent to which covered bonds, despite their limiting factors – such as falling coverage ratios, a dwindling volume of new mortgage business, regulatory minimum capital requirements as well as certain unsecured liabilities – can be used to raise additional funding on the capital markets.

> *"Traditional investors are increasingly returning to the primary and secondary markets."* *Jens Tolckmitt, Chief Executive, Association of German Pfandbrief Banks (vdp)*

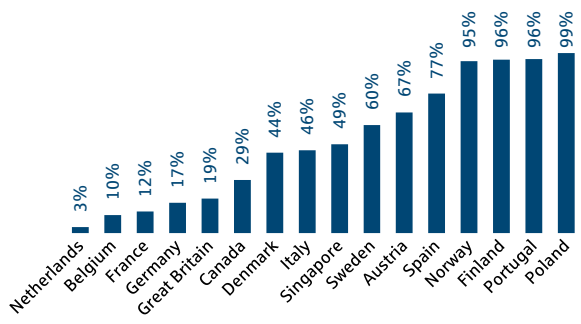
As far as investors are concerned, covered bonds represent an increasingly attractive instrument. In addition to their continued preferential regulatory treatment, investors are returning to this safe asset class due to rising yields, with even core segments meanwhile offering competitive coupons. In light of various uncertainties, such as high inflation or the energy crisis, and their varying effects on covered bonds across countries, issuers and cover pools, we can expect greater differentiation in risk premiums.

Primary market volume to remain at high level

All things considered, we anticipate that the arguments in favour of covereds will prevail, with the result that the primary market volume of around 160 billion euro will outstrip the volume of maturing issues (126 billion euro). A lack of eligible loans and the challenges posed by the EU taxonomy, as well as the proposed Green Bond standards, mean that the market for Green and Social covered bonds is only growing at a modest pace. In 2022 to date, sustainable instruments as a whole have reached a total volume of 16.6 billion euro, roughly the same as the previous year's impressive 17 billion euro issuance. The ECB also continues to play a major role as a buyer in this market. By September 2023, covered bonds in an amount of 44.8 billion euro are due to mature. The intention of the ECB's Governing Council has so far been to replace securities purchased under its asset purchase programmes (APP) in full at maturity for as long as necessary. Given a positive net supply and a certain level of demand from the ECB, we expect a moderate rise in risk premiums.

Major differences in interest rate models

Covered bonds: floating rates as share of cover pools* 2022, %



*countries and issuers selected from scope of our analysis
Sources: issuers' websites, Helaba Research & Advisory

Mortgage defaults likely in 2023

The Covid-19 crisis revealed that non-performing loans (NPLs) had barely any impact on the quality of cover assets. However, with interest rates increasing globally, 2023 can be expected to see a relative **growth in NPLs**. Despite this, we do not foresee any deterioration in credit quality over the coming year. In addition, due to the average **floating-rate portion** of mortgages, attention will turn to the composition of cover pools. Overall, though, there is no reason to doubt the high quality of crisis-resistant covered bonds. In most cases, comfortable over-collateralisation levels and LTV ratios provide sufficient buffers against any downturn in the market.

Christian Schmidt

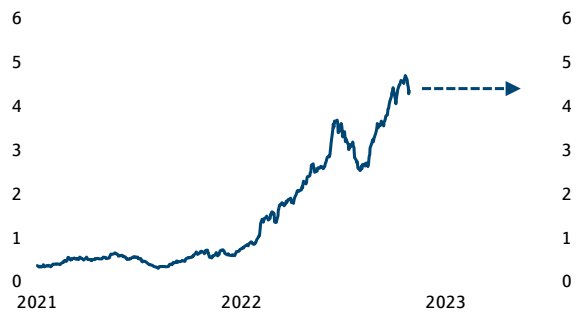
Credits: Refinancing costs to remain persistently high

A growing need for liquidity will prompt corporates to become more active on the bond market. Although banks will gain from rising interest rates, mounting credit defaults are on the cards.

Over the course of 2022, a sharp increase in swap rates and a significant widening of credit spreads have multiplied funding costs for many companies. The result was a veritable collapse of the **primary market for euro-denominated corporate bonds**. By the end of the year, we expect an issuance volume of only 250 billion euro, versus 360 billion euro in the previous year.

Yields to remain on high level

iBoxx € Corporates, yield, %



Sources: Refinitiv, Helaba Research & Advisory

Likewise, 2023 will leave precious **little scope for any loosening of base rates** given high inflation and efforts by the ECB to combat it. On a positive note, at least the peak in spreads will have been reached by the end of 2022. Growing clarity about the direction of the economy should contribute to alleviating uncertainty on the markets. Despite this, many companies will be faced with weaker internal financing capacities given the downturn in the economy. There is little doubt that banks will respond to deteriorating credit quality profiles and rising default rates with more **restrictive lending policies**. At the same time, companies will have limited room to postpone **essential investments** in sustainable business processes and a transformation of their supply chains. What is more, a number of corporate borrowers are likely to be forced to make up for previously deferred capital market-based funding operations. Overall, even if coupons continue rising, corporates are set to become more active on the euro-denominated bond market again. We forecast a total issuance volume of more than 300 billion euro.

Banks caught between rising interest income and higher credit defaults

As a result of the changed interest rate environment, the earnings outlook for banks in 2023 is **caught between rising interest income on the one hand and fears over higher credit defaults on the other**. Fundamentally, though, the industry is among the **winners of rising rates** in terms of earnings, as customer deposits and liquidity portfolios can be invested at more favourable conditions – something that financial institutions have already impressively demonstrated. In view of central bank policy in general, this trend is likely to continue.

However, a rapid jump in interest rates will have a detrimental effect on the **quality of credit exposures**. On top of this, there are a number of factors weighing on customer receivables including, for example, the high cost of energy that is acting as a challenge for corporate clients. Up to now, non-performing loans (that is, those for which customers have already defaulted on repayments) have remained stable at a low level. Yet the share of lending for which the problems are only just beginning to emerge (so-called Stage 2 loans) has already seen an increase. Furthermore, rising interest rates are putting pressure on earnings from securities, asset management and investment banking activities, among others.

Another focal issue in 2023 is likely to be the **overall provision of liquidity**. Whereas corporate demand for lending looks set to remain strong, banks' liquidity ratios may also decline due to monetary policy tightening and the phasing out of TLTRO funds. However, banks enjoy very strong liquidity ratios and, in addition, exhibit high capital ratios, which can largely be attributed to the regulatory reforms in the banking sector. All the same, bondholders are becoming increasingly selective given that their claims are subject to higher risks depending on their rank (so-called bail-in capital).

Ulrich Kirschner, CFA, Dr. Susanne Knips

Equities: 2023 offers above-average prospects for returns

It would be too tempting to simply extrapolate a gloomy scenario for 2023. But a lot of negativity has already been priced in and some indications are pointing in the right direction.

Most equity investors have had to endure hefty losses in 2022. Indices the world over have, in some cases, recorded **enormous price declines** of more than 20 %. That puts the most important stock market indices in bear market territory, with the tech sector registering the largest slump. Following the pandemic, digitisation fantasies catapulted valuations to what were in some cases astronomical heights. Consequently, these stocks have been the biggest losers from the rise in interest rates. That is because, just as the tide of liquidity gushing from central banks lifted the prices of (almost) all asset classes in recent years, so their **policy of monetary tightening** is now lowering them again. In contrast, energy stocks have been able to buck the trend. This sector is the only one in the STOXX 600, the broad aggregate for Europe, that has been able to boast handsome gains of more than 20 % at times.

This year has seen a war in Ukraine, exploding energy prices, concerns about the reliable supply of energy, runaway inflation as well as a significant rise in key and capital market interest rates, with all of this leading to fears of a recession dominating activity on financial markets. Equities are faced with a specific challenge, namely that central banks will be forced to continue **raising interest rates** as long as inflation remains elevated - even if it results in an economic downturn. This has exerted immense pressure on valuations, which were extremely high at the beginning of the current interest-raising cycle. Having said that, on balance inflation usually has a positive impact on corporate earnings. Higher profit margins show that companies on index level have been able to more than compensate for higher costs. So, despite the economic slowdown, corporate profits have performed surprisingly well to date. As a result, the valuations of leading international equity indices have noticeably recovered. **Euro-denominated stocks** provide **particularly attractive** opportunities.

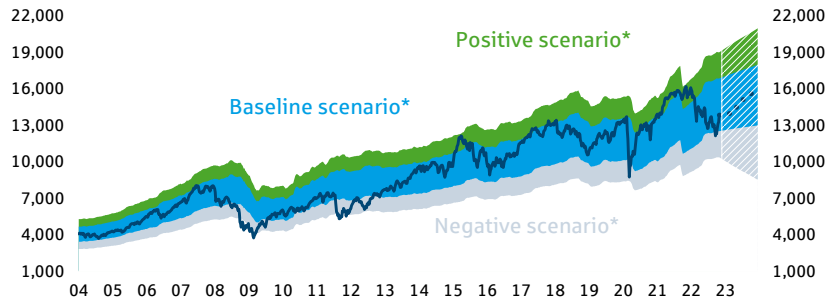
> *Most people base their expectations on extrapolating the prevailing trend.*
> *Own observation*

Green light for the DAX

At its peak, the DAX had lost as much as 26 % this year. That means the various negative factors have most likely been sufficiently discounted. There is scarcely anyone who can imagine that the fundamental situation will improve any time soon and this is reminiscent of past **bear markets and crises**. Although the triggers or causes are different (dotcom bubble, economic and financial crisis, sovereign debt crisis, pandemic), the effects are always the same: equities sustain considerable losses. And yet the downturn was always followed by a recovery. However, the challenge is getting the timing right, as equities run ahead of the economic cycle by about half a year and begin to rise even when the fundamentals and the news situation are still dismal. This is a phase normally associated with heightening volatility and may lead to further price setbacks in the short term. But it is precisely this **window of opportunity** that offers the **best chances for returns**.

DAX offers attractive risk/reward profile

Index, weekly



*bands: fair value consisting of earnings, dividends, cash flow and book value
Sources: Refinitiv, Helaba Research & Advisory

In other words, how is it possible to seize this opportunity while simultaneously minimising the risk of catching a proverbial falling knife? There are **four key conditions** for equities to **reach a floor**: cheap valuations, extremely negative macroeconomic expectations, very pessimistic investor sentiment and an equity index that is technically oversold in the medium term.

That is why we have selected the most useful indicators from the various segments of equity analysis - fundamental analysis, behavioural finance and technical analysis - and combined them into a single indicator: the **Helaba BEST indicator** (valuation, sentiment, technical). Meanwhile, this indicator has provided a clear "buy" signal. At the same time, all sub-indicators are flashing green for the DAX: valuations are favourable, economic expectations are already in deeply negative territory, investor sentiment is decidedly pessimistic and the DAX is technically oversold in the medium term. Hence, the chances that the German equity index has reached its floor are not all that bad. By the end of 2023, the DAX should be on track to hit the 16,000 mark.

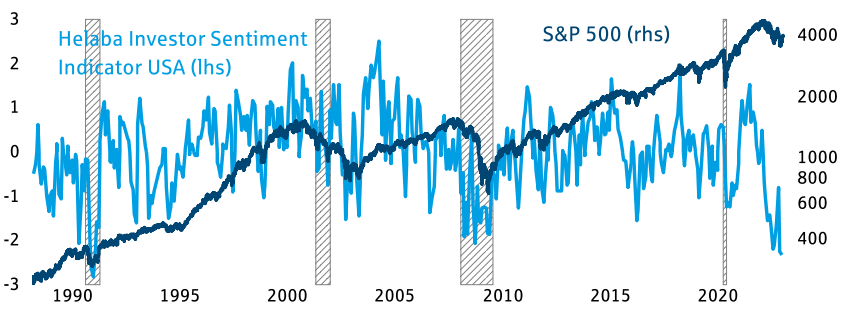
US equities also attractive

At its lowest point, the S&P 500 had lost 25 % of its value – similar to the DAX. The same negative factors apply to the US equity market as in Germany: inflation, interest rate hikes and fears over economic growth. Yet, economic sentiment stateside is not nearly as bad as it is on this side of the Atlantic. Among other things, this can be attributed to the fact that the immediate impact of the war in Ukraine was lower and that energy security is not an issue. Valuation is another factor that distinguishes the S&P 500 from the DAX. Although it is certainly true that the US index has undergone a significant loss in value to date, due to the considerably more pronounced overvaluation that it previously exhibited this has only resulted in **US blue chip stocks** meanwhile trading at **fair prices**, rather than falling to the cheap levels of German stocks.

> *"Whenever you find yourself on the side of the majority, it is time to pause and reflect."*
> *Mark Twain*

While the first two conditions for a bottoming out of the market – a cheap valuation and extremely negative macroeconomic expectations – have not yet been met, **investor sentiment** and an equity index that is technically oversold in the medium term have provided a **distinct buy signal** in the form of a contra-indicator. In the past, a similar level of pessimism among US investors, as measured by investor sentiment surveys and data on equity positioning, has been a reliable indicator of an approaching floor and subsequent **above-average rebound**. By the end of 2023, our forecast suggests that the S&P 500 will reach the 4,800 mark.

Distinct pessimistic sentiment favours equities



grey bands are US recessions
Sources: Refinitiv, Helaba Research & Advisory

Nothing ventured, nothing gained

Admittedly, it is far from easy to muster up the courage to invest in equities in times like this. Equity markets are always trading on the future, which is notoriously uncertain. But the only way to have the **chance of achieving above-average returns** is to be prepared to accept a **higher risk**. Weighing up risk is always a very personal matter. However, the risks associated with timing and single stocks can be substantially reduced by entering the market at different times and diversifying your holdings.

Index value	Q1/23	Q2/23	Q3/23	Q4/23
DAX	14,000	15,000	15,500	16,000
Euro Stoxx 50	3,850	4,100	4,150	4,200
S&P 500	4,250	4,500	4,650	4,800

Source: Helaba Research & Advisory

Markus Reinwand, CFA



Gold: Straddling a monetary policy tightrope

In their struggle to stem record inflation, central banks are putting pressure on interest-free gold. 2023 should see the pressure subside and demand for gold should rise.

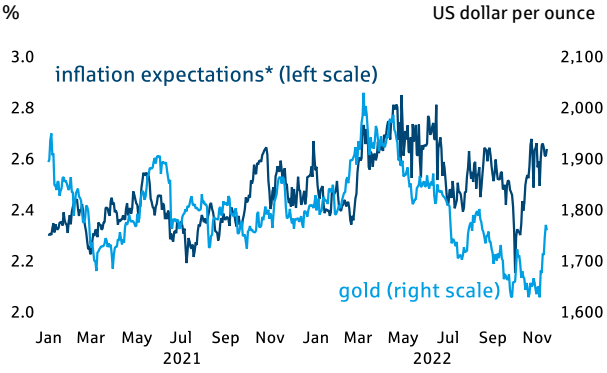
2022 was supposed to have been a **year for gold**. After all, the precious metal acts as a form of protection in crises, of which there has certainly been no shortage: Russia's war against Ukraine, energy and commodity shortages, supply chain disruption, very high inflation and now, in its wake, a looming stagnation of the global economy or recession in Germany. Fundamentally challenging conditions were practically tailor-made for gold. Yet, despite these circumstances, the gold price has been going steadily downhill, with the exception of a temporary high of just under 2,030 US dollar per troy ounce shortly after the outbreak of the Ukraine war at the beginning of March. So, 2022 is set to be another **negative year** with losses amounting to 3 %. Things look marginally better for euro investors, who will benefit from a gain of around 6 % thanks to the weakness of the single currency.

> *"Gold has worked down from Alexander's time... When something holds good for two thousand years, I do not believe it can be so because of prejudice or mistaken theory."*
> *Bernard Baruch, stock market speculator (1870-1965)*

Difficult territory due to rising interest rates

Even though prices are rising at historically high rates, gold is not functioning as an **inflation hedge**. This is due to the shift in central bank policy, most notably that of the Fed, which has taken aggressive measures to counter high inflation with steep hikes in interest rates. Gold, which does not bear interest, has suffered from mounting **opportunity costs**. The higher the pressure from interest rates, the further the gold price fell, even if the picture in real terms seemed to favour the precious metal. That said, weakness during a phase of rising interest rates is nothing out of the ordinary. In fact, past interest rate cycles have shown that, as soon as they end, opportunities for gold will return. Hence, the sooner the **fight against inflation** yields results in 2023, the faster gold is likely to strengthen. It is an upside-down world: gold cannot gain until the strain of rising interest rates diminishes. Does this mean that it has had its day as a hedge against inflation?

Gold detached from inflation expectations



*inflation expectations on capital market = USD 5Y5Y inflation swap forward
Sources: Macrobond, Bloomberg, Helaba Research & Advisory

Well, that depends on how seriously monetary policymakers take the fight or what level they will consider acceptable beyond their stated objectives. The more challenging the macroeconomic environment becomes in the course of the year, the more politically difficult it will be to justify further interest rate hikes. For the Fed and the ECB, this constitutes a delicate balancing act: they have to dispel any impression that they have not done enough to tackle **high inflation**. By the same token, they have to avoid economic turmoil. Given high levels of **government debt** in both economic areas alone, monetary policy is likely to lean slightly in favour of growth.

In demand again as an inflation hedge

In 2023, **demand is likely to rise** for gold as an **insurance policy against elevated inflation** in conjunction with **weaker growth**. There will be no repeat of the monetary policy worst case scenario during the tenure of Fed Chairman Paul Volcker in the 1980s, who defeated inflation with radical interest rate hikes but at the cost of the worst US recession since the end of the Second World War. Volcker simultaneously ushered in a protracted period of weakness for gold, which was ultimately not broken until the onset of the financial crisis in 2007. Neither the Fed, nor even the ECB, will tread this course. Consequently, the gold price will consolidate above the 1,900 US dollar per troy ounce mark.

Price / ounce	Q1/23	Q2/23	Q3/23	Q4/23
Euro	1,714	1,714	1,727	1,727
USD	1,800	1,800	1,900	1,900

Source: Helaba Research & Advisory

Claudia Windt

Real Estate: Downhill from lofty heights

The boom on Germany's real estate market has peaked. Interest rates, more than recession, are the underlying cause of this turning point. This will squeeze real estate returns.

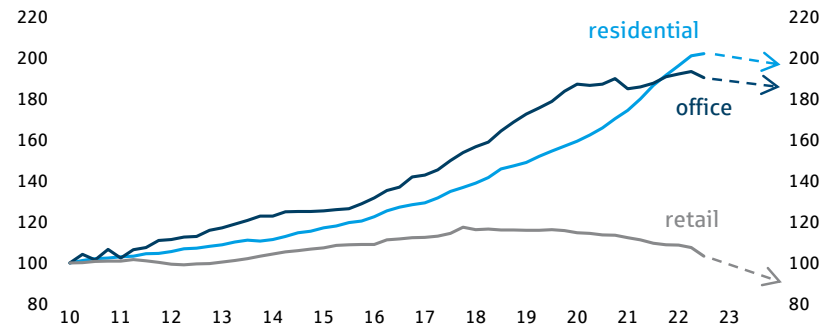
During the Covid-19 pandemic, the German property market demonstrated its resilience, with the exception of segments such as retail and hotels, which were particularly impacted by the lockdowns. Now, the war in Ukraine and the ensuing energy crisis are bringing on the next recession. What is especially pertinent for real estate this time is that no help can be expected from the central bank. On the contrary: the monetary policy reversal has led to a **sharp rise in interest rates**. A drastic increase in financing costs and the lower relative attractiveness of this asset class are likely to result in **declining prices**. However, we believe that fears of a crash or even a bursting of a real estate bubble are overblown. We anticipate a **modest correction** which, following a sustained boom spanning many years, will once again reveal the cyclical nature of the asset class. As is so often the case, there are major differences between individual market segments to be aware of.

Interest rate shock weighs on residential property market

Having been on a downward trend for decades, mortgage rates have more than tripled within a short space of time. This has added to the **worsening affordability of residential property**, which is now also reflected in a sharp drop in financing new construction projects. Although the need for additional housing in Germany is still high, and has increased further due to refugees from Ukraine, higher interest rates are depressing demand for owner-occupied properties. To some extent, this will migrate to the **rental housing market** and put more upward pressure on rents.

Upward trend on German property market over

vdp Property Price Index Germany, capital value, Q1 2010 = 100



Sources: vdp, Helaba Research & Advisory

The era of steeply rising house prices is a thing of the past. Whereas the increase in the third quarter according to the German Pfandbrief Association was still as much as 6 % year-on-year, we are probably looking at negative rates over the course of 2023. However, since it is not only demand but also supply that is falling at the same time, the negative **effect on prices should remain limited**.

> *"To be absolutely clear: we adhere to our goal."*
>
> *The German Chancellor Olaf Scholz at the presentation of a package of measures by the Alliance for Affordable Housing*

Key indicators, such as the number of building permits and incoming orders, are clearly pointing downwards. In addition, the hefty rise in construction costs and material shortages, as well as a noticeable lack of skilled workers, are **putting the brakes on construction activity**. A number of proposed initiatives (such as more modular construction, faster approval processes) are fundamentally a step in the right direction but it is not feasible that they will be realised in the short term. That means that the German federal government's target of building 400,000 new dwellings per year will not be achievable in 2023. We expect a further **decline in new completions** to 270,000 units.

Commercial real estate: Office more stable than retail

The tougher economic environment will not leave the commercial real estate market unscathed. As a result, some commercial projects may no longer be profitable in a changed capital market landscape and will therefore be shelved. In the **office segment**, leading German locations are still proving surprisingly resilient. Following high

rent growth of 5-6 % p.a. in the pre-Covid years, thanks to strong office employment they have recently continued to register modest increases. However, for next year we only expect prime locations to see **stable office rents**.

Since they bottomed out in 2019, vacancy rates have already risen by around 1 ½ percentage points. Work from home has likely contributed to this, prompting a number of companies to make more efficient use of office space. This process is set to continue, albeit at a very gradual pace. At the same time, the rather high level of completions in 2022 is having a lingering impact. Since this additional space will not be fully absorbed, we anticipate a further slight **increase in office vacancy rates** in Germany's top locations in the new year.

% yoy	2019	2020	2021	2022e	2023f
Open-ended fund index*	2.7	1.5	2.0	2.2	2.0
Residential real estate**	6.4	6.8	10.3	7.5	-2.0
Commercial real estate**	6.4	3.1	-0.8	0.0	-2.5

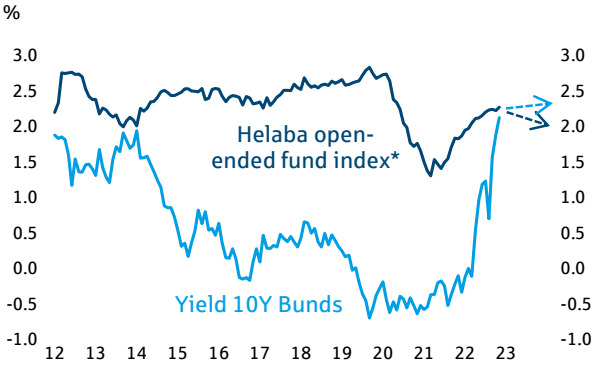
* Helaba index für German open-ended funds (annual total return); **vdp price indices Germany (annual average), f=forecast; Sources: vdp, Refinitiv, Helaba Research & Advisory

Although we expect largely unchanged property values for high quality offices in good locations in 2023, **retail properties** are likely to experience a **continued weaker performance**. For years now, they have been suffering from fierce competition from online retailers. This is meanwhile being compounded by an enormous loss in purchasing power among consumers due to high inflation, which is casting a cloud over prospects for the industry. Both of these factors will put sustained pressure on property values and rents in this segment in 2023.

Open-ended real estate funds: Moderately lower performance

The returns of **open-ended mutual property funds** had only just emerged from the pandemic-induced dip and, since the spring, had once again breached the 2 % mark. Most recently, their average performance, as measured by the "Helaba OIF-Index", had reached 2.3 %. Considering the challenging economic climate in the most important investment countries for these funds as well as the negative impact of higher interest rates, returns are likely to be somewhat lower in 2023.

Significant drop in relative attractiveness



*total return, average of nine major German open-ended real estate funds
Sources: Refinitiv, Helaba Research & Advisory

Nevertheless, rather than any sharp slump, such as during the COVID-19 pandemic, we forecast a more muted trend **towards 2 %** by the end of 2023. After all, real estate markets typically react to cyclical conditions with a **time lag**. For example, the latest performance data from the most important foreign market for open-ended mutual property funds, France, with a share of around one tenth of the open-ended funds' portfolios (Germany: 36 %), does not yet reflect a downturn.

In traditionally more volatile markets, such as the United Kingdom or the United States (each of which also has a share of 10 %), total returns on commercial real estate have already fallen significantly from high levels or even declined slightly. Another factor that leads to a delayed reaction compared to listed investments is the specific way in which properties are valued by appraisers in open-ended real estate funds.

For investors, the appeal of open-ended real estate funds is not only determined by their performance, but also by the returns of alternative investments. Given the current yields on 10-year German bunds, they no longer offer any risk premium compared to the return on open-ended real estate funds. This is leading to **net inflows** into the fund category **declining**, something which was already apparent in the last few months. They should reach an estimated 5 billion euro in 2022 as a whole, before falling considerably short of this level in the new year.

Dr. Stefan Mitropoulos

Currencies: Dollar riding on thin air

The US dollar has done much to capitalise on a near-perfect constellation for it, posting strong gains. But 2023 will see this tailwind ebbing away and the US currency depreciating.

The US dollar has reaped the benefits of a rare combination of a noticeably more restrictive Fed policy and a flight to safety in 2022. The US currency rallied across the board, while the **EUR/USD exchange rate** plunged **below parity** for the first time in 20 years. The trade-weighted dollar index touched highs not seen for many years – the strongest it has been in real terms since the mid-1980s. Could the "greenback's reign" last in 2023?

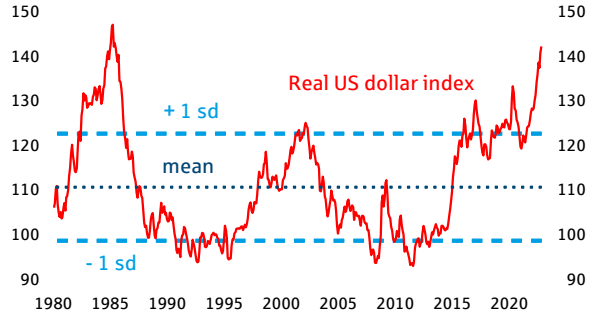
Factors driving dollar to lose momentum

This time around, the Fed has raised its key interest rates much more rapidly than in previous cycles. That has increased the short-term **US yield advantage** over the euro area, making the dollar more attractive. In principle, as long as there are no signs of an end to interest rate hikes, there is nothing to slow the tailwind behind the dollar. However, the extreme heights to which it soared in the eighties were predicated on much steeper rate hikes into double digits, which is extremely unlikely to happen today. In 2023, the economic impact of monetary policy tightening will be felt and inflation will subside so that an **end to interest rate hikes** will then be in sight. Moreover, other central banks such as the ECB will step up the pace of reining in inflation. Over the course of the year, the US yield advantage is therefore set to recede and the currency will face a slight headwind.

Meanwhile, anxieties over the war in Ukraine and Europe's energy security are also spilling over into the forex markets. Yet again, the **greenback** is sought after **as a safe haven for investments** in choppy waters. At the very least, the severity of the energy crisis should subside in 2023; and once the most pressing economic challenges have been resolved, sentiment on the financial markets will pick up again. Ergo: the US safe-haven currency will lose its appeal.

Dollar soars to dizzying heights

Index, narrow trade weighted



Sources: Macrobond, Helaba Research & Advisory

Dollar's high valuation makes it vulnerable

To some extent, the US economy has been able to benefit from the energy crisis. For one thing, higher exports of liquefied natural gas (LNG) are improving the country's balance of trade. Yet, energy exports are only marginally lowering trade and current account deficits. The cost advantage that it enjoys in terms of energy, which is meanwhile much more pronounced, is offset by the elevated value of the dollar. The "twin deficit" – i.e., the combined total of budget and current account deficits – has receded from the record levels seen during the pandemic, but still remains above average. In terms of purchasing power parity, the **dollar's overvaluation** against the euro has soared to a level that was previously only seen for a few months in 1984/1985. Globally, there are serious reservations being voiced about the dollar's strength; but in the US itself, there has so far been little criticism. In view of geopolitical tension, many are even casting doubt on the dollar's role as the world's reserve currency. However, whichever way you look at it, there is simply no alternative to the dollar.

> *"But the dollar has become a wrecking ball, rising far higher than one would expect based on fundamentals. Its extraordinary spike is driven by investors who think the dollar is the only haven and speculators betting that it will keep rising."*
> *Ruchir Sharma, Investor*

While the dollar may well remain the "king" on foreign exchange markets, it is likely to lose momentum in 2023. That does not rule out the possibility, when markets get the jitters, that the greenback will temporarily scale new heights. Ultimately, though, the tailwind will wane. By the same measure, the **EUR/USD rate** will recover as the year progresses and be trading significantly **above parity**, even reaching as much as 1.10 at its peak.

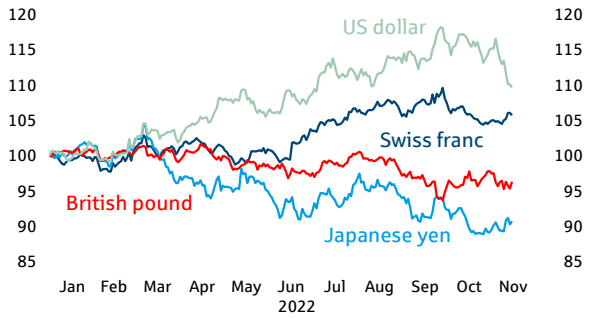
Pound sterling to stabilise

The **pound sterling** has come under pressure, not only depreciating against an overbearing dollar but even against the euro. Political turbulence due to irresponsible fiscal policy was the trigger for the sharpest spikes. Economies with high current account deficits, such as the UK, are vulnerable to shocks like this. In the medium term, though, a mixture of **very high inflation coupled with recession** will have a much more serious impact.

But at least the political institutions in the UK are still running. The new government is seeking to pursue a more solid fiscal policy. The Bank of England is set to **raise its key interest rate substantially**, which will boost the relative attractiveness of sterling. Notwithstanding volatility, this should stabilise the currency at a low level for the time being. While a recession due to price and interest rate shocks is inevitable, the country will be able to emerge from it as 2023 unfolds, especially since inflation will start to subside. That should **lift underlying confidence in the currency**. The EUR/GBP rate is likely to settle at around 0.85 at the end of 2023.

2022: Dollar the winner, yen the loser

Performance vs. euro, indexed 31.12.21 = 100



Sources: Macrobond, Helaba Research & Advisory

Swiss franc to weaken

Yet again, the Swiss currency has proven its mettle in times of crisis and has posted gains relative to its European counterparts, with the EUR/CHF rate slipping below parity. Moreover, the **safe haven** was supported by the monetary policy turnaround in Switzerland: The SNB raised its key interest rate into positive territory. The bank also appears to have shed its fear of an overly strong franc and is not expected to intervene against its own currency in the near future. After all, the franc's appreciation is putting a damper on inflation, which is relatively low, at around 3 % in Switzerland in 2022.

As a rule, an environment of rising yields has an adverse effect on the franc, as the **yield disadvantage of the franc** increases due to higher rate hikes by the ECB or its predecessors. That is also evident this time round: the euro's interest rate advantage has achieved magnitudes similar to those seen ten years ago, when the exchange rate was considerably higher. In addition, demand for the franc as a safe-haven currency should decline in 2023. Past lofty heights will remain out of reach, but at least the EUR/CHF rate should find its way back to **above parity**.

Japanese yen: potential for recovery

Among the leading global currencies in 2022, the **Japanese yen** was the **big loser** and was almost edged out by the classic soft currencies from Argentina and Turkey. And yet Japan is a long way from the Ukraine war and its inflation rate is relatively benign. Seemingly, the yen is no longer considered a safe haven. But unlike the Swiss franc, the Japanese currency is reeling from the **global rise in yields**. The rate advantage of the dollar, and even of the euro, over the yen has widened markedly and sent the currency into a tailspin. Above all, because the Bank of Japan, in contrast to the SNB, has so far not wavered in its zero interest rate policy or efforts to steer the yield curve. Instead, it has been intervening to halt the currency's downward slide. Presumably, under new BoJ leadership in 2023, even minor adjustments would suffice to support the currency. After all, in terms of purchasing power parity, the yen's **undervaluation** against the dollar has already reached **dramatic proportions**. That should also make Japan a more appealing place to invest. In addition, the global rise in yields should taper off. While there is even a significant potential for the yen to rally against the US dollar, it should make up some ground against the euro.

vs. Euro	Q1/23	Q2/23	Q3/23	Q4/23
US dollar	1.05	1.05	1.10	1.10
Japanese Yen	145	142	142	140
British Pound	0.88	0.87	0.85	0.85
Swiss franc	1.00	1.02	1.04	1.05

Source: Helaba Research & Advisory

Christian Apelt, CFA

European Union: Well-trodden paths will lead to dead ends

Russia's war against Ukraine will impact the EU's economy and politics for years to come. Balancing the disparate interests within the Union will be a critical factor.

Russia's invasion of Ukraine in February 2022 came as a shock to the European political and economic establishment and its consequences will reverberate for years to come. This not only applies to economic aspects. **Securing energy resources and, in particular, food supplies** are issues of global significance that the EU also has to factor into its crisis management. It would not be sufficient to focus exclusively on its member states.

Previous assumptions about supply chains, which policymakers had taken for granted, have become obsolete and present the EU with the challenge of rapidly finding new and viable alternatives. As far as energy security is concerned, the RePowerEU plan, launched in April 2022, seeks to cut energy consumption, boost energy efficiency and reallocate energy sources, among other things. However, it is debatable as to whether the new dependencies to which the EU is tying itself will be viable. Additionally planned measures, such as price caps, taxes on windfall profits and the decoupling of the electricity and gas prices, will shape the EU's economy over the next few years. The need to balance immediate **relief for consumers** with issues of **competitiveness** and maintaining the **attractiveness of the EU** as a location for business and investment complicates things.

> *"…we also have to acknowledge a new reality of higher public debt."*
> *Ursula von der Leyen, President of the EU Commission*

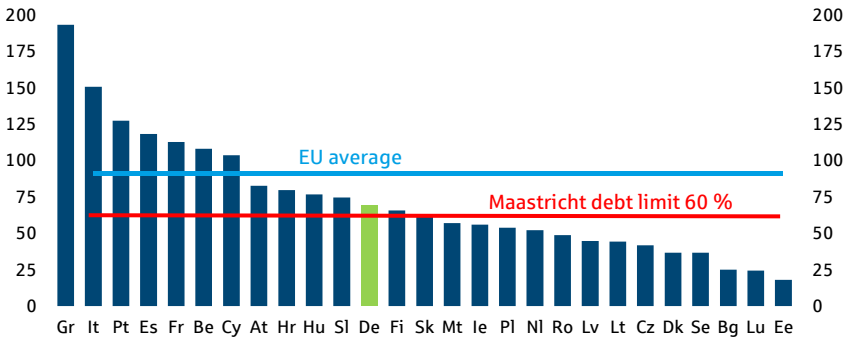
Furthermore, the degree to which EU member states are dependent on Russian energy varies according to their energy mix and their own resources. That makes it harder for all EU countries to work in unison, a weakness that has been on full display in terms of the widely divergent opinions regarding sanctions against Russia. Yet, the myriad challenges Europe faces underline the importance that the **EU must speak with one voice** on the international stage. Proceeding along well-trodden paths is likely to lead to a dead end. This is also reflected by the vast array of issues requiring action, outlined by the President of the EU Commission in her autumn 2022 State of the Union Address. The political dimension has taken on far greater weight, and not only in her remarks. Living up to these aspirations will be virtually impossible without institutional reforms.

Issue of public finances could resurface with a vengeance

To some extent, these pressing concerns are relegating issues such as the taxonomy for sustainable activities to the background. What is still at the forefront of the debate is the **ecological dimension of sustainability**, inextricably linked to energy security but fraught with conflict in the trade-off between economic and environmental considerations.

Debt burden of member states varies widely

Gross government debt 2021, % of GDP



Sources: Eurostat, Helaba Research & Advisory

Another crucial aspect of sustainability is **financial viability**. Currently, member states are facing enormous financial pressure. EU budgetary reforms with multi-year instead of annual indicators, as outlined by the EU in November, will provide them with greater flexibility in terms of lowering their debt. However, whether this approach is effective at a time of rising interest rates remains to be seen. In any case, the Maastricht ceilings have been suspended until the end of 2023 and it is unlikely that tough austerity measures will be imposed after that date. So, there are bound to be growing calls for new common debt issuance.

Marion Dezenter



Germany: Caught in violent headwinds

The second half of 2022 has seen Germany sliding into recession. This is likely to be followed by no more than a moderate recovery. High costs jeopardise the future of the industrial base.

	2022e	2023f	2024f
GDP real, % yoy	1.4	-0.8	1.3
GDP real, % yoy, working day adjusted	1.5	-0.6	1.3
Private consumption, % yoy	4.0	-0.5	1.5
Government spending, % yoy	4.3	2.3	1.0
Gross fixed capital formation, % yoy	0.5	-0.8	1.5
Investment in equipment, % yoy	1.0	-1.0	2.0
Construction, % yoy	0.0	-1.0	1.0
Exports, % yoy	2.0	2.5	3.0
Imports, % yoy	6.0	4.0	3.0
Consumer prices, % yoy	8.0	6.0	3.5
Unemployment rate, %	5.3	5.7	5.3
Unemployed, thousands	2,450	2,600	2,400
Budget balance, % of GDP	-3.5	-2.5	-2.0
Current account balance, % of GDP	7.2	5.2	4.7

e=estimate, f=forecast; Source: Helaba Research & Advisory

This crisis is different. For the first time, Germany is not only confronted with what is expected to be a mild **recession**. It also faces the threat of stubbornly high prices for natural gas and electricity, which **jeopardise the competitiveness** of the country as an industrial hub. This problem can only be solved in the medium term by a massive expansion in the energy supply, not only of gas but, more importantly, of electricity.

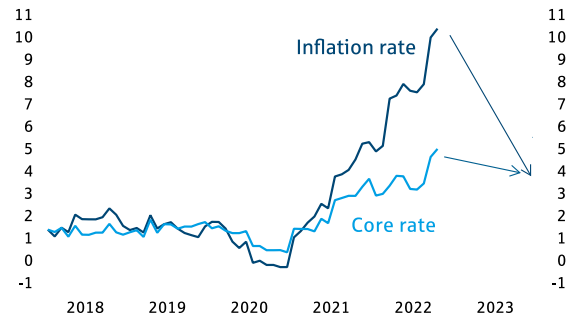
The ifo business climate index has deteriorated significantly since the onset of Russia's military campaign against Ukraine. Exploding prices for natural gas, electricity and a variety of commodities have resulted in spiralling costs for businesses. Since these costs can only be passed to customers to a limited extent, many companies are finding that their **manufacturing** activities have become **unprofitable**. At the same time, consumers and industrial buyers are reluctant to spend. But these problems are not confined to Germany. **High inflation**, which is partly the consequence of a belated response by major central banks, is a global phenomenon. As a key beneficiary of international trade, Germany is feeling the effects of this in terms of weaker exports – in part because governments are increasingly adopting **measures** to combat the crisis that are **harmful to globalisation**.

The German government is trying to cushion the downturn with **relief programmes**. The three packages approved so far amount to around 135 billion euro, or about 3 ½ % of total economic output. The measures include one-off payments for pensioners and students, an expansion of housing benefit entitlements and the elimination of tax bracket creep. On top of this, it has also created a 200 billion euro fund to rescue companies in the energy sector and to lower natural gas prices. These measures will reduce uncertainty and contribute to providing a cyclical boost over the course of 2023, enabling the **German economy to return to growth in the spring**. Despite this, a contraction in gross domestic product of -0.6 % can be expected for 2023 as a whole.

> *Relief packages can only help in the short term. If the government wants to ensure that manufacturing industry stays in the country, it must also pursue a coherent energy policy.*

Inflation: No sufficient improvement

% year-on-year, according to definition used in Germany



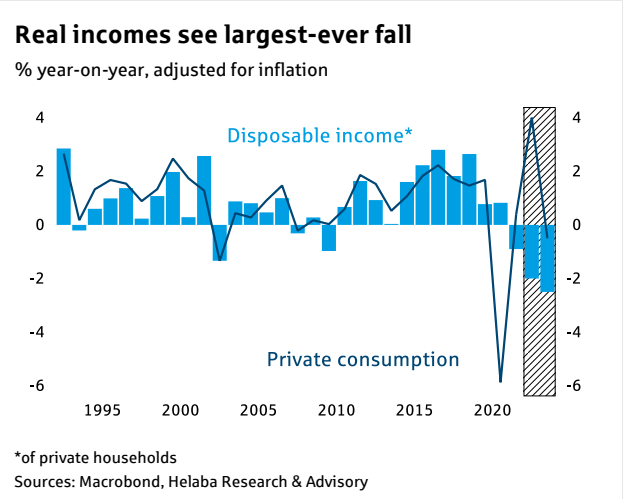
*excluding food and energy
Sources: Macrobond, Helaba Research & Advisory

Inflation to remain above 2 %

The **gas price cap** and equivalent measures to limit electricity prices will have a positive effect on inflation at the beginning of 2023. However, this will not go far to solving the inflation problem. On the contrary, high energy prices have already "eaten into" various groups of products. The significantly higher minimum wage, which came into force in October 2022, and higher collective bargaining settlements (or demands) are putting additional pressure on prices. In the medium term, an increasing **shortage of labour** and **measures to combat climate change** will result in higher prices. Following an average **inflation rate** of 8 % in 2022, prices are expected to rise by a further substantial 6 % in 2023.

Falling real incomes of private households

In 2022, **consumer spending** is estimated to have risen by 4 %. This was due to pent-up demand for many services in the wake of the Covid-19 pandemic. However, a reversal of this trend had already set in during the second half of the year. This is reflected in a fall in retail sales, adjusted for inflation. Rising wages are not able to compensate for high inflation and the savings rate has declined to pre-2020 levels. Even if the latter falls even further, the stimulus it provides will be more limited. Recently, there has been almost no rise in **employment**. However, the recent increase in **unemployment** is primarily due to the fact that Ukrainian refugees have been included in jobless statistics since June.



At just under 5 %, the increase in collective bargaining salaries is not expected to offset inflation in 2023. What is more, following a strong boost in government support payments as a result of the pandemic, the increase in these transfers will be smaller next year. The incomes of self-employed persons are even likely to shrink, so that total disposable incomes in 2023 will rise by an estimated 3.5 % in nominal terms. This represents a considerable reduction in real terms. Nevertheless, **consumer spending** should only decline by 0.5 % as previously high levels of savings are run down.

Investment in capital equipment rose by an estimated 1 % in 2022 - but is therefore still around 8 % lower than before the Covid-19 crisis. Economic uncertainty and declining corporate profits, together with rising capital market interest rates, will hold back capital formation for the time being. That said, at least the gas price cap for SMEs and manufacturers will provide more predictability in terms of energy costs and companies will be forced to invest more in energy efficiency and digitisation. That should mean that capital expenditure on equipment will recover in the course of 2023, although it will be slightly lower on average for the year as a whole.

Significant demand for new construction – weaker underlying conditions

The same holds for **investment in construction**. Although it is likely that limited capacity as well as a shortage of raw materials and intermediate products will gradually recede, rising construction costs and interest rates will increasingly take their toll on budgets. Incoming orders in the construction industry are falling in real terms and some projects are being cancelled. Business sentiment has soured noticeably. The construction of new single-family homes is also being dragged down by the challenging income situation of private households. Given these conditions, German policymakers' goal of building 400,000 new dwellings per year will not be achievable and an estimated 270,000 new dwellings will be built in 2023. One positive side effect of high energy prices is that they will stimulate energy-efficient modernisation, including the installation of more efficient heating systems.

2022 already saw less favourable growth in investment in commercial real estate than in the other two construction segments. This is unlikely to change in 2023 due to the cyclical woes the industry faces. At least the strong investment activity by the German national railway company, Deutsche Bahn, will have a positive impact. Public sector budget planning suggests that spending will remain high in 2023. However, due to steep price increases, the best that can be expected from public infrastructure spending is a stagnation in real terms.

The negative contribution that German **exports** made to growth this year is likely to decline in the course of 2023 as a recovery sets in. The main drivers for this will come from the United States and the euro area. Notwithstanding discussions about Germany's trade relationship, China should provide additional opportunities for German companies.

Dr. Stefan Mütze



France: Reducing debt not foremost on the agenda

The French economy is set to weather the crisis with minor blemishes. It may even manage to avoid a recession altogether, partly thanks to even higher public spending.

When it comes to dealing with today's crises, France is proving more resilient than Germany. Even after having recovered from the Covid-19 slump, the country is growing at a more buoyant pace. In 2022, **gross domestic product** (GDP) will have gained around 2.5 %, before slowing to 0.5 % in 2023. In both cases, this represents around one percentage point more than Germany.

Unlikely to slip into recession

To put it bluntly: France is less dependent on Russian gas than Germany. Electricity is the main source of heating and the importance of a gas-dependent industrial sector is considerably lower. The country was quick to start putting a cap on electricity and gas tariffs, which is expected to be extended into 2023. The new budget also contains additional funds for defence, the police and the judiciary, as well as measures to alleviate tax bracket creep. It is unlikely that the government will make any further progress in reducing the **budget deficit** which is projected to reach minus 5.5 % in 2023. The government is sticking to its goal of meeting the Maastricht criterion of achieving a budget deficit of 3 % or below by 2027 (for the first time in twenty years). Since the president has lost his parliamentary majority, the danger is that he will be forced to pay a high price in order to buy the agreement of other parties in the Assemblée nationale.

		2021	2022e	2023f	2024f
GDP, real change	% yoy	6.8	2.5	0.5	1.5
Inflation rate	% yoy	2.1	5.7	3.8	3.0
Unemployment rate	%	7.9	7.4	7.0	6.5
Budget balance	% GDP	-8.5	-5.0	-5.5	-4.0

Sources: Macrobond, Helaba Research & Advisory

French consumers also holding back

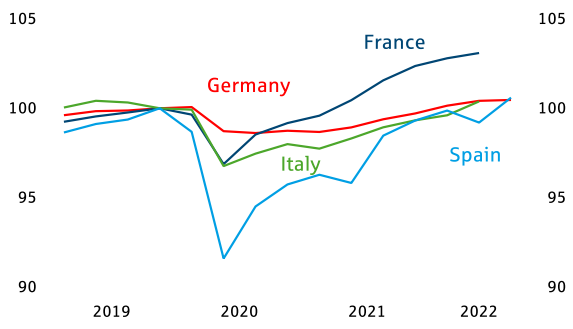
Inflation is expected to come in well below the euro area average at 5.7 % in 2022 and an estimated 3.8 % in 2023. In addition to the price cap on gas and electricity tariffs, the fuel price rebate for drivers has also contributed to this. In spite of this, high food prices, in particular, are weighing on French consumer spending. Although the previous year's low level due to the pandemic should mean the latter will have risen by a considerable 2.5 % in 2022, recently there have been clear indications that the trend is slowing down.

Recent strikes are likely to contribute to higher **wage settlements** in 2023 than in the previous year of around 3 ½ %. A further decline in the savings rate and rising labour force participation may support this development. However, the momentum provided by the latter will fade in 2023. Helped by higher social security benefits, **consumer spending** is expected to grow by less than 1 %.

The most noticeable impact of global crises will be on **investments in capital equipment**, which has already declined somewhat in 2022. Uncertainty among businesses is not going to disappear in the short term in France, either. Business sentiment has fallen, particularly in the retail sector. Spending on capital equipment should gradually recover in the course of 2023. However, confidence in the construction sector remains largely intact. Having grown by less than 1 % this year, **construction investment** is likely to stagnate in 2023. French **foreign trade** has acted as a drag on growth in 2022. In 2023, imports are once again likely to somewhat outpace exports.

French employment supports consumption

Workforce, Q4 2019 = 100



Sources: Macrobond, Helaba Research & Advisory

Dr. Stefan Mütze

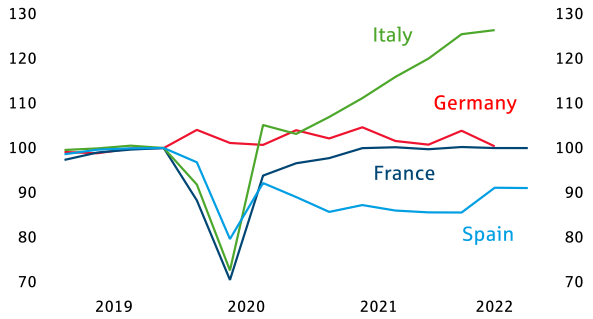
Italy: A historic opportunity

Italy is basking in the glow of economic success. Whether this will last is partly down to the new government. The country faces a precarious balancing act in 2023 with a modest growth.

In the wake of the reformist government of Mario Draghi, Italy is now embarking on a **fresh political start** under the far-right politician Giorgia Meloni. It remains to be seen, however, just how stable her three-party coalition government will ultimately prove to be and whether it will carry out any further necessary structural reforms. Recently, the economy has put in a "bella figura" performance and the country has succeeded in making up for the dramatic economic crash triggered by the pandemic - in fact, today it is even bigger than it was pre-Covid. Now, it is likely that there will be some minor setbacks in **economic output**. But there should be a brisk rebound from spring 2023 and, for the year as a whole, Italy is expected to post **marginal GDP growth**. Manufacturing industry in Italy is also reeling from skyrocketing energy and commodity prices, and Italian households are struggling with **inflation**.

Italy: sharp rise in investment

Construction investment, adjusted for inflation, Q4 2019 = 100



Sources: Macrobond, Helaba Research & Advisory

Booming investment activity

That said, the **generous EU funds** from Brussels come in handy. Apart from cohesion funds of more than 40 billion euro until 2027, the country is also entitled to transfers of around 70 billion euro from the Recovery and Resilience Facility. The condition attached to these funds is that mandated reform objectives, such as in the civil service, are achieved. This could benefit projects to digitise the economy and protect the environment, and also explains Italy's sharp growth in investment. Currently, **construction and capital equipment investments** are around 30 % and 15 % higher, respectively, than before Covid-19. So far, business sentiment has only fallen slightly. **Fixed capital formation** should continue to pick up in 2023.

> *For Italy, billions of euros in funding from Brussels are a historic opportunity to take the country forward. The new government should grasp it.*

Business confidence in the construction sector has reached a high level. In addition to infrastructure, there is also rising investment in **residential construction**, a sector that had ended years of decline as early as 2015. In 2022, the pace of investment in residential construction has accelerated significantly, with real growth of around 11 %. Until recently, in spite of higher mortgage rates, the number of building permits and prices of residential property have been rising. In 2023, it should be possible for the residential construction sector to achieve moderate gains.

Insecurity among private households

At 3 %, **consumer spending** also saw a sharp rise in 2022 in Italy, too; however, the outlook for 2023 is less encouraging. Consumer confidence has declined markedly here. Wages are not able to keep up with soaring inflation. The extent to which the new government approves **tax relief** or transfers to mitigate the burden of high energy costs, for example, remains unclear. Despite a further drop in the savings rate, consumer spending is only expected to stagnate in 2023. Once again, **foreign trade** will have a negative effect on economic growth.

		2021	2022e	2023f	2024f
GDP, real change*	% yoy	6.7	3.3	0.2	1.7
Inflation rate	% yoy	1.9	7.8	4.3	3.0
Unemployment rate	%	9.5	8.1	7.7	7.2
Budget balance	% GDP	-7.2	-5.3	-4.5	-3.5

*calendar adjusted; Sources: Macrobond, Helaba Research & Advisory

Dr. Stefan Mütze

Spain: Less vulnerable to a crash

Spain has not yet recovered from the Covid-19 slump. However, the current crises are not affecting the country as badly and it should manage above-average growth.

Since the Covid-19 pandemic, Spain has not only been lagging behind the euro area average but has also been overtaken by the other major Mediterranean country, Italy. Recently, however, **momentum has picked up**. In 2022, economic growth should reach an estimated 4.4 % (euro area: 3.1 %) and, at 1% in 2023, is also expected to outperform the single currency area as a whole. The shock of the **energy crisis** has had a less dramatic impact on Spain, as the country can rely on key gas suppliers such as Algeria and boasts a well-developed infrastructure for liquefied petroleum gas.

		2021	2022e	2023f	2024f
GDP, real change	% yoy	5.5	4.4	1.0	2.0
Inflation rate	% yoy	3.0	8.8	4.3	3.5
Unemployment rate	%	14.8	12.6	12.1	11.3
Budget balance	% GDP	-6.9	-5.0	-4.0	-3.5

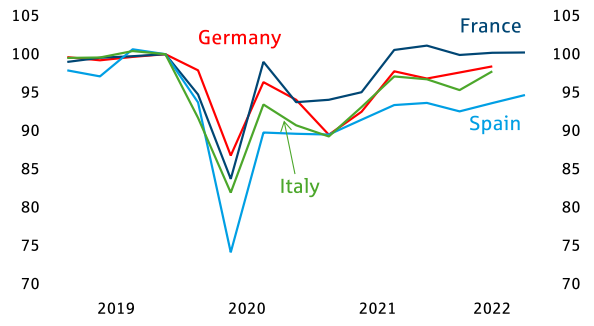
Sources: Macrobond, Helaba Research & Advisory

Private households reluctant to take extravagant family outings

At 8.8 %, **inflation** in 2022 is above the European average but the price cap on gas and electricity will contribute to bringing it down to 4.3 % in 2023. Consumer sentiment is more downbeat than in other euro area countries. Real disposable incomes are falling because wage increases are not able to compensate for soaring inflation. This is unlikely to change in 2023, either. Although the savings rate has returned to its pre-pandemic level, the persistently high level of savings is likely to be eroded further. In addition, rising employment and support for the low paid will have a positive effect on incomes. **Consumer spending** is expected to grow by less than 1 % in 2023.

Spanish consumers less spendthrift in 2023

Consumer spending, adjusted for inflation; index: Q4 2019 = 100



Sources: Macrobond, Helaba Research & Advisory

Lacklustre investment

Spain is entitled to transfers of around 77 billion euro from the EU's Recovery and Resilience Facility. This comes on top of other cohesion funds, bringing total transfer allocations to around 113 billion euro, in addition to subsidised loans, by 2027. In spite of this, **investments** in **capital equipment** have only recently returned to their pre-Covid level and construction investment, in contrast to Italy, still falls significantly short of this mark. In 2023, though, this could change if additional funds are disbursed and they are more effectively converted into actual investments. However, business sentiment has deteriorated and companies are likely to exercise restraint when it comes to capital formation due to the weaker global economy. What is more, upcoming **elections** in key regions and, at the end of the year, for the national parliament are fuelling uncertainty. Rising mortgage rates and the worsening income situation of private households are hampering **residential construction** activity. On balance, **fixed capital formation** is only likely to rise marginally in 2023.

Economic growth in Spain was supported by **foreign trade** in 2022. Exports are projected to have grown by 18 %, twice as fast as imports in real terms. Meanwhile, the slowdown, particularly in the European economy, is having an increasingly adverse effect on them. Some 55 % of exports are destined for other euro area countries, the most important being France and Germany. Foreign trade is not expected to contribute any momentum to growth in 2023. Last summer, the **tourism sector**, which plays such a crucial role for the country's economy, rebounded to pre-pandemic levels. However, 2023 will probably see more hesitant spending by European holidaymakers as their real incomes decline.

Dr. Stefan Mütze



Sweden: Finding new ways out of the crisis

The Swedish economy is unlikely to improve until the second half of 2023. The government is breaking new ground in both domestic and foreign policy, while interest rates continue to rise.

An economic environment that has rapidly cooled and a pessimistic outlook among consumers do not augur well. Although gross domestic product (GDP) will have grown by just over 2 % in 2022 thanks to a strong first half, it is set to **flatline in 2023**. Weaker conditions among key trading partners and consumers' diminished purchasing power are dragging down the Swedish economy. On the upside, unemployment has fallen back to pre-Covid levels. But the central bank is expected to **miss its 2 % inflation target** by a wide margin in 2023, as well.

		2021	2022e	2023f	2024f
GDP, real change*	% yoy	4.8	2.3	0.2	1.2
Inflation rate	% yoy	2.2	8.4	8.0	8.0
Unemployment rate	%	8.8	7.4	7.6	7.0
Budget balance	% GDP	-0.1	-0.3	-0.2	0.5

*calendar adjusted; Sources: EU, Eurostat, Helaba Research & Advisory

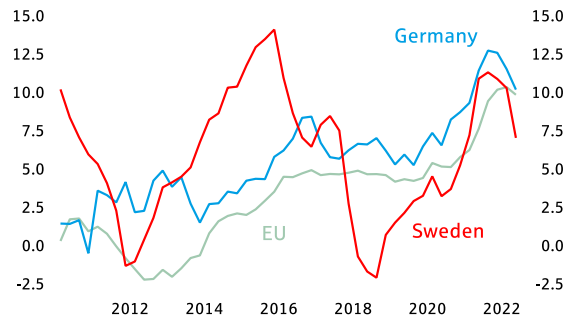
Sweden is less severely exposed to the current shortages than other countries by virtue of its diversified energy supply. The country only imports a limited amount of natural gas and oil from Russia, since its primary energy sources are nuclear power, biofuels/waste-to-energy as well as oil, which is mainly obtained from Norway. Together with supply chain disruptions, though, soaring global prices for energy have sent producer prices through the roof. As long as there is no significant decline in energy prices, **higher food prices in addition to housing and transportation costs** will continue to weigh on consumer spending. Second-round effects pose the risk that inflation will remain persistently high should the employees seek to offset higher costs with corresponding wage rises.

Riksbank to continue tightening for some time – housing market set to cool

The **Riksbank** will initially adhere to its **policy of monetary tightening**. Hikes in the key rate since April 2022 are likely to be followed by further steps that are expected to lift it above the 3 % mark by spring 2023. However, other factors will have a greater impact on the EUR/SEK exchange rate, including foreign policy developments and momentum on equity markets. On balance, the currency should be trading closer to 10 kronor to the euro again over the course of 2023. The housing market, which will see a sharp correction amid surging interest rates, construction and consumer prices, should rebound as the year goes on.

The housing market is losing momentum

House prices, % year-on-year



Sources: Macrobond, Helaba Research & Advisory

New government, NATO and EU Presidency

The war in Ukraine has prompted a radical rethink in Sweden, with political neutrality being **jettisoned in favour of NATO membership**. Along with Finland, the country applied to join the alliance in May and aims to substantially boost its defence spending. Before its membership can be formally approved, it still has to reach agreement with Turkey, which is calling for more decisive action against groups that it classifies as terrorist organisations. Hungary also has yet to ratify Sweden's accession.

> *"The deal stands."*
> *Ulf Kristersson, Swedish prime minister*

The **minority government** that was formed after September's parliamentary elections and the new prime minister, Ulf Kristersson, are leading the negotiations. His in-tray includes a broad range of challenges: NATO accession, a sluggish economy and the fight against organised crime are among them, in addition to the controversial accord with the nationalist Sweden Democrats, who the centre-right coalition relies on for support in parliament. Furthermore, Sweden assumes the Presidency of the Council of the European Union in January 2023.

Marion Dezenter



Poland, the Czech Republic, Hungary: Economic risks due to clashes with EU

In addition to the economy, the focus in Central and Eastern Europe is on relationships among CEE states as well as towards the EU. Their quality has impacts on finances and economic growth.

The convulsions unleashed in Europe by Russia's attack on Ukraine will have ramifications far beyond 2023. It will not just hit the economy; the conflict will also put **ties between the CEE states and their relationship with the EU** to the test. The Czech Republic, which holds the Presidency of the Council of the European Union in the second half of 2022, is the most likely of CEE states to seek close links with the Union. In contrast, Poland and Hungary are torn between national autonomy and a desire not to jeopardise urgently needed EU funds. Hungary with its strong ties to Russia and China, has at times exploited the approval of sanctions as a bargaining chip.

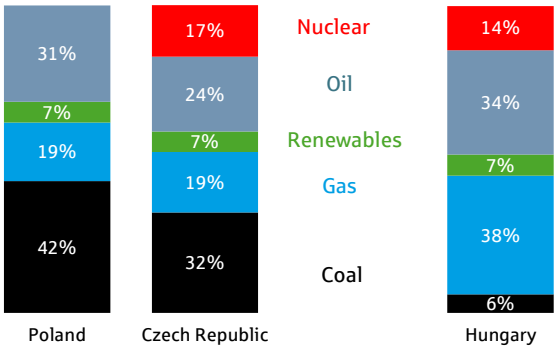
What all three countries have in common are supply chain bottlenecks, high prices, steep interest rate hikes and a challenging macroeconomic outlook, all of which are driving down business and consumer confidence. This is weighing on consumer spending and investment, albeit demand is also being stimulated by the arrival of refugees from Ukraine, especially in Poland and the Czech Republic. Weak economic activity in key trading partners, such as Germany, is weighing on foreign trade. None of the three countries is expected to achieve **economic growth** in 2023 of more than 1 %, which would be the second-lowest figure after 2020 for roughly ten years.

Inflation remains a concern

Energy security will be a pivotal issue in 2023, as well. On this front, Poland was quick to lay the groundwork at an early stage for diversifying supplies but technical problems and the belated signing of contracts mean that, for the time being, energy prices will remain high. In all three countries, **price caps** and, in some cases, direct subsidies are designed to soften the blow for consumers. Beyond that, the governments want to expand the use of nuclear power but this will involve longer lead times.

Energy mix: Different starting points

Sources of energy, proportion of total energy consumption in 2021



Sources: Our World in Data, Helaba Research & Advisory

In 2023, consumer prices will be somewhat held in check by monetary policy tightening, muted demand as well as a base effect. **Higher wages** pose a risk, as labour markets are relatively tight and workers will be looking to recoup at least some of their purchasing power lost to inflation. Therefore, the average annual inflation rate is expected to stay, for the most part, in double digits. Parliamentary elections in Poland in October 2023 will ensure that the pressure to ease the burden on consumers will remain high.

Softer currencies add momentum to inflation

Since the onset of the Ukraine war, the Hungarian currency, in particular, has weakened significantly and is **adding to inflationary pressure from imports**. A more EU-friendly approach by the government would benefit the forint and thus make an important contribution to lowering inflation. In Poland, the impact of the exchange rate is less pronounced, while the Czech koruna is even seeing a slight appreciation against the euro. Here, the fact that the new government, elected at the end of 2021, is not on a collision course with the EU is paying off. In order to steady the exchange rates, the countries are intervening directly on currency markets, if necessary.

		Poland				Czech Republic				Hungary			
		2021	2022e	2023f	2024f	2021	2022e	2023f	2024f	2021	2022e	2023f	2024f
GDP, real change	% yoy	6.7	3.6	1.0	3.0	3.5	2.1	0.6	2.7	7.1	4.7	0.8	3.3
Inflation rate	% yoy	5.1	13.9	10.0	4.2	3.8	16.0	9.4	3.0	5.1	13.0	11.5	3.5
Unemployment rate EU	%	3.4	2.7	3.1	2.9	2.8	2.4	2.9	2.7	4.0	3.6	4.5	4.2
Budget balance	% GDP	-1.8	-3.8	-3.3	-2.7	-5.1	-5.0	-4.7	-4.5	-7.1	-6.5	-6.0	-5.0

*calendar adjusted; Sources: EU, EIU, Macrobond, Helaba Research & Advisory

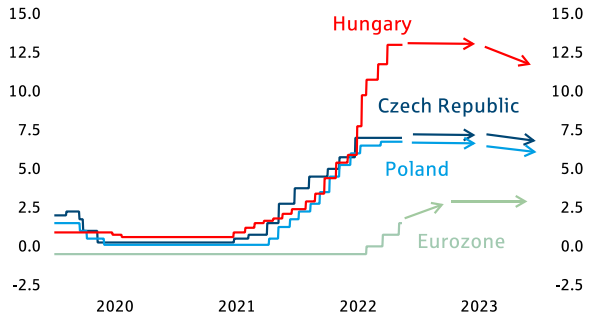
A dilemma for central banks

However, future trends in exchange rates also hinge on how rigorously the central banks pursue the fight against inflation. For they find themselves in a genuine dilemma, as the weak economy would favour a policy of monetary accommodation. But inflation has soared far beyond all targets and investors' risk aversion is weighing on the three countries' currencies. Steep hikes in interest rates since 2021 have increased the cost of borrowing and put the brakes on economic growth. One purpose of these rate moves is to prevent high **inflation expectations** becoming entrenched, which would trigger a spiral of anticipatory demand leading to further inflationary pressure.

Communication by the central banks reflects this ambivalence. For instance, a comment about upcoming easing in the Czech Republic was followed by statements qualifying this move; in Hungary, although the central bank has declared an end to the cycle of interest rate hikes, it is instead using short-term instruments to steer monetary policy. The first **interest rate cuts** in the region are expected in the **second half of 2023**, after which the interest rate level will still remain relatively high.

Cuts in key interest rates in second half of 2023

Key interest rate, %



Sources: Macrobond, Helaba Research & Advisory

Higher interest rates are also having an impact on public finances, as a **substantial jump in bond yields** is pushing up the cost of government borrowing. This is compounded by fiscal measures designed to support households and businesses in dealing with the fallout from the crisis. Therefore, net borrowing, in some cases, will remain substantially above 3 %. Nevertheless, gross debt to GDP should remain comfortably below the EU average at between around 40 % (Czech Republic) and 70 % (Hungary).

Deteriorating relations with EU pose risks to fiscal and economic stability

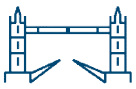
The future direction of the economy and public finances is closely intertwined with relations with the EU. Poland and Hungary, which have been the subject of frequent criticism from Brussels, particularly for their interference in the judiciary, must reach a workable and lasting agreement on this issue. If they fail to do so, they risk being deprived of **cohesion funds,** having **recovery funds** blocked and losing the confidence of investors. From the Cohesion Fund alone, more than 20 billion euro has been earmarked for Hungary and over 70 billion euro for Poland until 2027. That is equivalent to around 13-15 % of GDP in 2021.

> *"Central Europe is our common home, we have common interests."*
> *Mateusz Morawiecki, Polish prime minister*

Recently, Poland has seemed less inclined to compromise, whereas Hungary has established an Integrity Authority to investigate cases of suspected improper use of EU funds from November 2022. There is a question mark over whether this will suffice to placate the EU or whether additional steps will be required. The **incentive to de-escalate the situation** should be high as the failure to obtain EU funding and high interest rates on government bonds will push up the price of the conflict and, hence, significantly turn up the heat on domestic politics. Should no agreement be reached, the EU Commission appears determined to penalise a breach of common values this time.

The four countries of the **Visegrád Group** (Poland, the Czech Republic, Hungary and Slovakia) are seeking to improve their mutual ties, which have been strained by their varying stances towards Russia. In the past, they have already thrown their **collective political weight** behind EU votes on issues such as migration. Having fallen out with each other when Hungary took a divergent position on sanctions against Russia, the aim of top-level discussions is now to bring about a rapprochement among the Group's members.

Marion Dezenter



United Kingdom: Plunge averted

Following a tumultuous year marked by high inflation and a looming recession, things can only get better. After a hard time, the economy should bounce back again in the course of 2023.

For the UK, 2022 has been an "**annus horribilis**": the Queen passed away, three prime ministers passed through Downing Street and financial markets shredded the government's fiscal plans as if they were from an emerging market. Meanwhile, inflation leapt to previously unimaginable heights as the economy took a drastic turn for the worse. So, 2023 will be all about damage limitation and stabilising the country's position. This might just succeed with a more stringent monetary policy and sounder fiscal management under the new prime minister, Rishi Sunak.

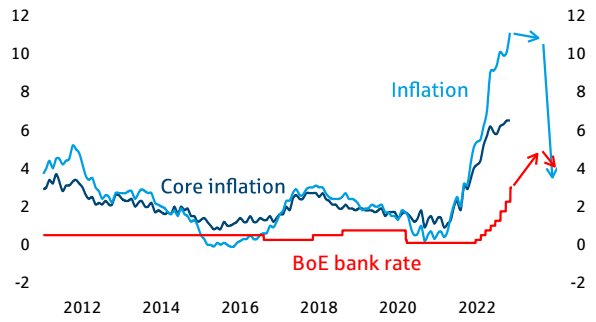
Sliding into recession

The British economy had such a flying start to the year that, despite a contraction in the second half, gross domestic product (GDP) climbed by an overall 4.4 %. However, as a result of the energy price shock, a steep rise in inflation and tighter monetary policy, the **economy** is likely to **hit the brakes**. In particular, the winter half year will be marked by a substantial downturn, with consumer spending being especially hard hit. **Shrinking real incomes** are putting the squeeze on private households. At least a drop in the savings rate and additional government support, most notably a price cap on electricity and gas prices, are cushioning the decline in consumer spending and the impact on the labour market has only been modest.

> *Liz Truss is already a historical figure (…) she is set to be remembered as the prime minister whose grip on power was the shortest in British political history. (…) she had seven days in control. That is the shelf-life of a lettuce.*
> *The Economist*

Softening demand will dampen the appetite of businesses to invest, which in turn will drive their spending down. In the wake of its abortive tax cutting plans, the government enjoys limited scope to help and the most it can do is provide a modicum of growth stimulus. The extremely high trade deficit will narrow on the back of weaker domestic demand.

Inflation problem will ease in 2023



Sources: Macrobond, Helaba Research & Advisory

Inflation to pass its peak

At more than 10 %, **inflation** in the UK has been more severe than in other larger economies. The core rate, which excludes energy costs, jumped very sharply. **Brexit** was also a factor in this, as it is associated with a shortage of workers and less competition among businesses. However, as demand falls, passing on price increases should become more difficult and, thanks to base effects, inflation should ease back to a "mere" 6.5 % over the course of 2023. The **Bank of England** is likely to hike the key rate to 4.5 % into the spring and could even cut it again as the year draws to a close.

		2021	2022e	2023f	2024f
GDP, real change	% yoy	7.5	4.4	-1.0	1.5
Inflation rate	% yoy	2.6	9.0	6.5	3.7
Unemployment rate	%	4.5	3.8	4.4	4.5
Budget balance	% GDP	-8.0	-6.5	-5.0	-3.0

Sources: Macrobond, Helaba Research & Advisory

With **inflation subsiding**, real incomes will stabilise and the shock of higher prices will gradually dissipate. In the **second half of the year**, sentiment should generally pick up and the **economy** is then likely to **return to growth**. For 2023 as a whole, we project a contraction in GDP of 1 %. As long as politicians do not throw any further spanner in the works, next year will end on a more conciliatory note than in 2022.

Christian Apelt, CFA



United States: Recession rather than inflation – or both?

2023 will prove decisive in the US in determining whether the Fed is able to contain very high inflation without precipitating an economic crash. We only expect a mild recession in the first half of the year, followed by a gradual recovery. But there is plenty of scope for missteps. The data over the next few months will decide how far the Fed will go.

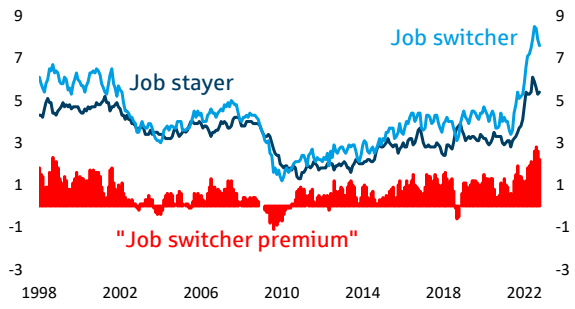
Weak growth in 2023 has become the consensus view. Disagreement focusses on just how bad it will be. We count ourselves among the **optimists** in this respect. Perhaps counterintuitively, the central rationale here is the unique impact of the pandemic, which ultimately sparked a number of economic problems that persist to this day.

Consumer spending to come under pressure

Aggregate demand has mainly been underpinned by private households in 2022, despite a fall in real incomes. The declining savings rate, which is responsible for this, was facilitated by an accumulation of **excess savings** during the pandemic. But this effect will not be sustainable in the long run. For 2023, we expect unemployment to rise in the wake of substantial monetary tightening (see chapter Monetary Policy). However, the increase in the jobless rate should be modest, as companies have likely learned a painful lesson during the pandemic when a shortage of labour supply rapidly led to a "bidding war" for workers. Nevertheless, in an environment such as this, there is unlikely to be any significant growth in consumer spending. The recent **surge in wages**, which the Fed also regards as a major source of inflation, should gradually subside.

Over the peak – but still a workers' market

Average hourly earnings, % year-on-year*



*premium: difference between both series in percentage points
Sources: Federal Reserve of Atlanta, Helaba Research & Advisory

Interest-rate sensitive components of demand will be particularly hard hit. Especially the housing market is already seeing a marked correction. This will probably eventually involve an absolute fall in house prices, which had gone up sharply in previous years.

This time, **investment in capital equipment** – usually one of the biggest accelerators of recessions brought on by rising interest rates – should hold up comparatively well in spite of high levels of debt in the corporate sector. Current capex ratios are extremely low, there are still production bottlenecks and the shift in climate policy will encourage US companies with an international footprint, in particular, to invest more heavily in greener equipment.

Tight monetary policy, largely neutral fiscal policy

In 2023, fiscal policy will not offset monetary tightening. Significant fiscal stimulus is unlikely over the next one or two years. A substantial amount of fiscal consolidation took place during 2021 and 2022, which had a tangibly dampening effect on economic activity. President Biden's largely tax-funded “Inflation Reduction Act” and his student loan forgiveness programme will provide limited support for future demand on net.

However, after the midterm elections of 8 November 2022, the president looks set to lack a congressional majority to pass any further initiatives. Based on the current (15 November) vote count, the Republicans seem poised to win a majority in the House of Representative. In the Senate, though, Democrats maintained their lead. **Losing their House majority** will stop Democrats from using their previous strategy of getting all sorts of economic priorities passed via budget reconciliation. In any case, the historically high level of public debt limits the space for fiscal policy initiatives at a time of rising interest rates.

Overall, we anticipate **economic growth of 0.5 %** in 2023, with output contracting slightly in the first six months before a recovery takes hold. As this is not expected to be supported by either fiscal or monetary policy, it should prove rather anaemic.

> *"The idea that [the 2021 fiscal stimulus] caused inflation is bizarre."*
> *Joe Biden in June 2022*

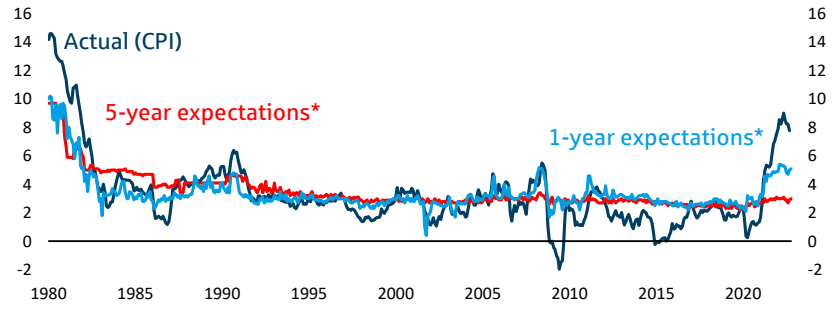
Will a mild recession such as this be enough to tame inflation? Sceptics are fond of invoking the past, which suggests that any noticeable reduction in inflation is always a protracted and painful process. To be sure, it is not going to be a walk in the park this time round, either. At the same time, one should not overstate the significance of the past and many people still underestimate the **unique nature of the pandemic shock**. This is not only a lesson to learn for those economists who in 2020 told us that it would take until 2025 or even 2030 before US unemployment would return to its pre-pandemic level. In fact, it had already done so by the spring of 2022.

Inflation: The stickiest consequence of the pandemic?

Simplifying a lot, the spurt in US inflation since the start of 2021 can be explained by **four factors**, three of which are directly related to the pandemic and its aftermath: First, a **shift in demand** from services to goods, which has yet to be corrected (at least in the US), leading to global supply bottlenecks and rising prices of the latter. Second, a **shortage of available workers** that has driven up wages and is only slowly abating (and will probably not completely disappear). Third, an **outsized stimulus** provided by monetary and fiscal policymakers that fuelled booming demand and resulted in the 2020 recession hitting supply relatively harder than demand. The significance of these three factors is receding, albeit in some cases more gradually than originally hoped. The strained global supply chains will only return to a largely normal state in 2023.

Long-term inflation expectations firmly anchored

Expected and actual inflation, %



*University of Michigan consumer survey: expected average annual inflation on a 1-year and 5-year horizon
Sources: Macrobond, Helaba Research & Advisory

The fourth factor was a major spike in prices on the energy and food markets in 2022 unleashed by Russia's **invasion of Ukraine**. This helped to propel inflation above an average of 8 % in 2022. Meanwhile, though, commodity markets (at least outside of Europe) are also heading back towards conditions that are more normal.

		2021	2022e	2023f	2024f
GDP, real change	% yoy	5.9	1.8	0.5	1.8
Inflation rate	% yoy	4.7	8.1	4.0	2.5
Unemployment rate	%	5.4	3.7	4.7	5.0
Budget balance*	% GDP	-12.3	-4.5	-5.0	-4.5

*Federal incl. Social Security
Sources: Macrobond, Helaba Research & Advisory

As the after-effects of the pandemic fade away, this will reduce inflation in 2023 without the Fed having to curb demand significantly. However, this process is likely to be gradual, especially for core inflation. We still expect prices to rise by an average of 4 % over the year (core: 4.8 %). This will almost certainly test the Fed's patience. But compared to his predecessor Paul Volcker, Jay Powell has one crucial advantage: so far, unlike in 1980, consumers' **inflation expectations** are firmly anchored.

Patrick Franke

Japan: Limited inflation

The Japanese economy is poised to expand by 0.7 % in 2023. Compared to other industrialised countries, inflation remains manageable – if unusually high for Japan.

The world's third-largest economy is on a moderate growth trajectory. Having regained its pre-pandemic level in mid-2022 and grown by an estimated 1.3 % on average over the year, Japan's GDP is expected to gain 0.7 % in 2023. This is in line with the country's current growth potential. Japan's ageing population is the main underlying factor behind its **fundamentally weak growth performance**.

Frequent stimulus packages result in high national debt

The recent decision to **reopen the country** to foreign tourists and a further economic **stimulus package** drawn up by the prime minister, Fumio Kishida, raises hopes that the country may be able to avert a recession. The main intention of the package is to cushion the impact of inflation, which was sparked by the war in Ukraine and is now spreading across the third-biggest economy in the world. However, frequent stimulus measures in the past have left Japan grappling with a high national debt, which now stands at around 240 % of GDP.

Subsidies and sensitivity suppress price pressure

Unusually high inflation in Japan

% yoy



Sources: Macrobond, Helaba Research & Advisory

In relation to other industrialised economies, though, inflation has been limited. While higher food prices and the weakness of the yen, which primarily stems from a widening yield gap between domestic and foreign government bonds, are precipitating **noticeable inflationary pressure**, the actual recorded inflation rate is currently being suppressed by **government subsidies** on petrol, for example. On top of that, the acute **price sensitivity** of Japanese consumers restricts producers' scope for passing on price rises, which dampens inflation in the overall economy. Given these factors, in addition to modest economic growth, Japan's inflation rate is likely to stand at 1.5 % in 2023.

To some extent, Japan has responded to the energy crisis with something of a **nuclear renaissance**. In addition to expanding renewable energy sources, the country is embarking on the construction of new nuclear power stations with special safety features and restarting previously decommissioned power plants - more than a decade after the reactor catastrophe in Fukushima. A country with scarce natural resources, Japan regards nuclear energy as a necessary, all-weather element of its energy mix. In this sense, there has been a rethink in Japan over nuclear power.

> *"Renewable energy and nuclear power are indispensable for promoting the Green Transformation."*
> *Prime Minister Fumio Kishida*

		2021	2022e	2023f	2024f
GDP, real change	% yoy	1.7	1.3	0.7	1.0
Inflation rate	% yoy	-0.2	2.5	1.5	1.0
Unemployment rate	%	2.8	2.7	2.7	2.8
Budget balance	% GDP	-5.7	-6.0	-5.0	-4.0

Sources: Macrobond, Helaba Research & Advisory

Ulrike Bischoff

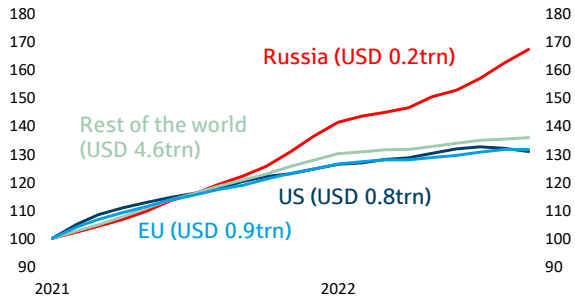
China: On a collision course

China is facing many domestic challenges. This may be why the country's political leadership is adopting an increasingly aggressive stance internationally. The potential for conflict is rising.

At the Party Congress in October, Xi Jinping secured at least another five years as China's paramount leader. Within the Chinese Communist Party (CCP), he holds a level of power arguably unmatched since Mao Zedong's reign. But it remains to be seen whether he will be able to use it to tackle the enormous **domestic and foreign policy challenges** that China faces. On both fronts, Xi has already proven himself to be a hardliner: a nationalist and a staunch advocate of the CCP's autocratic rule. Siding with Russia over the Ukraine conflict, threatening Taiwan and launching frequent diatribes against the United States and "the West" are just a few recent examples of this.

Realignment – starting as early as 2021

China's nominal foreign trade (imports plus exports)*



* 12-month-sum, indexed to January 2021 = 100; absolute amounts in brackets: cumulated foreign trade from Oct. 2021 to Sep. 2022
Sources: Macrobond, Helaba Research & Advisory

Domestic demand floundering

Two home-grown problems, both of which ultimately stem from political choices, are currently weighing particularly heavily on China's economy. On the one hand, the crucial **real estate sector** has plunged into a crisis after the government intervened. Even if the state manages to contain the situation without it turning into a crash, the sector will act as a drag on growth and consumer sentiment in 2023. It is highly likely that any attempt to stabilise the property market will require a substantial injection of public funds.

> *"Political power grows out of the barrel of a gun."*
> *Mao Zedong*

On the other hand, Xi so far remains fully committed to his "**Zero-Covid-policy**", which has already weighed on the country's growth in 2022, when cities such as Shanghai were put into lockdown in the spring. Ongoing restrictions imposed on the population will hurt consumer sentiment and stifle domestic demand in 2023, as well. However, first tentative steps towards a somewhat less draconic approach to the pandemic indicate that this factor may be less of a drag than in 2022.

Boost from net exports

In foreign policy terms, the trade and technology dispute with the United States is still a major issue. Yet, despite concerns over container ports "lying idle" at times, foreign trade is a bright spot for the economy. For one thing, China benefits from the supply of **cheap commodities from Russia** and its companies are replacing Western suppliers that have withdrawn from this market due to sanctions. But even trade with Europe and the United States continues to thrive and that is not likely to fundamentally change in 2023. Disentangling Western economies from China would be a protracted and arduous process, especially since it is unclear exactly how committed the West really is to such a course of action at the moment.

		2021	2022e	2023f	2024f
GDP, real change	% yoy	8.2	3.5	5.0	5.0
Inflation rate	% yoy	0.9	2.5	2.5	2.5
Unemployment rate	%	3.9	4.0	3.9	3.8
Budget balance	% GDP	-6.1	-9.0	-7.5	-7.5

Sources: Macrobond, Helaba Research & Advisory

On balance, despite greater stimulus efforts, China can be entirely satisfied with an expected **growth rate of 5 %** in 2023. This forecast is based on relatively optimistic assumptions for the negative factors affecting the domestic economy. Thus, the resulting downside risks specific to China could render the country a source of uncertainty and an additional drag on economic growth, even in our baseline scenario.

Patrick Franke



Russia: An unprecedented process of transformation

The impact of sanctions has forced Russia to restructure its international trade relationships. Although the economy will emerge from its trough in 2023, the outlook remains tempered.

The Russian economy's unprecedented restructuring process, which began in 2022, will continue into 2023. Companies are looking for new markets for their goods and are forced to find new suppliers for intermediate products. Due to the war in Ukraine, there is no chance of a political thaw and therefore sanctions will remain in place. That means a key market for Russia will be lost: In 2021, as much as around a third of exported goods were destined for the European Union. Despite this, the **scope of sanctions has been largely exhausted** and, consequently, the impact of further punitive measures would be less severe. One major risk for the country would be secondary sanctions, which would interfere with Russia's trade with non-European countries.

The recession will be followed by a **stagnation** in 2023. Uncertainty is significantly greater than usual, as the economic outlook is subject to exceptionally volatile (foreign) political factors. The likely scenario is that there will be a bottoming out in the first half of the year and that gross domestic product (GDP) will start to grow again in the second half. However, sanctions will continue to restrict the country's growth potential in subsequent years.

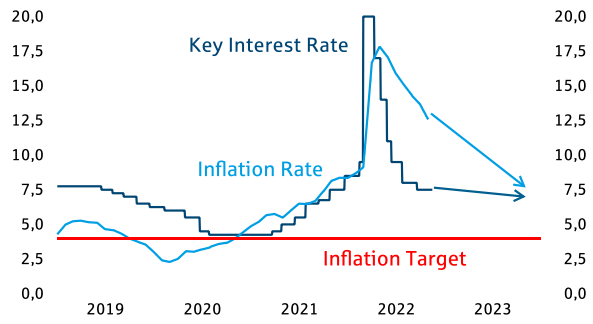
Investments and exports will decline further in 2023, which is bad news for Russia as **redirecting exports from west to east** will necessitate considerable investment in infrastructure. On the labour market, too, there is a need for new skills. Companies have no choice but to look for alternatives to Western suppliers in China and other Asian markets. That brings with it the risk of manufacturing bottlenecks, especially as other products and equipment pose new challenges for the workforce. For instance, new skills have to be acquired first and companies could increasingly lay off employees or be unable to find new ones immediately. From a record low in 2022, unemployment is likely to rise slightly in 2023 but should not become a large-scale problem.

		2021	2022e	2023f	2024f
GDP, real change	% yoy	4.7	-9.0	0.0	2.0
Inflation rate	% yoy	6.7	16.0	9.0	3.6
Unemployment rate	%	4.8	4.3	4.8	4.9
Budget balance	% GDP	0.4	-3.1	-2.4	-1.3

Sources: Macrobond, Helaba Research & Advisory

No scope for further interest rate cuts

% or % yoy



Sources: Macrobond, Helaba Research & Advisory

2023 will only herald a modest recovery in consumer spending, as uncertainty about job security and disposable incomes persists. At least there will be a **degree of respite in terms of prices**. Inflation will fall to 9 % in 2023 but will remain well above the central bank's target of 4 %. As the **Bank of Russia** has slashed the key interest rate in several steps from a high of 20 % to single digits since the beginning of the war in February 2022, there is little scope left for further cuts in 2023.

2023: Oil and gas revenues under pressure

The greatest **support for the economy continues to come from fiscal policy**. The ability of the Russian government to prop up the country depends heavily on oil and gas revenues, as just over half the country's foreign exchange reserves of 550 billion US dollar (as of October 2022) have been frozen by Western central banks. Given the oil embargo imposed by the EU at the end of 2022 and the fact that Russian oil is trading at a discount to other types of oil, revenues from commodities will be lower in 2023. The high level of military spending is another factor weighing on public finances. It is still very difficult to gauge the state of public finances because Russia no longer publishes any detailed statistics as a result of the sanctions.

Patrick Heinisch

Brazil: Robust growth despite challenging environment

Though commodity exports will decline, the domestic economy will demonstrate its resilience in 2023. Should the situation deteriorate, the central bank is on hand to cut interest rates.

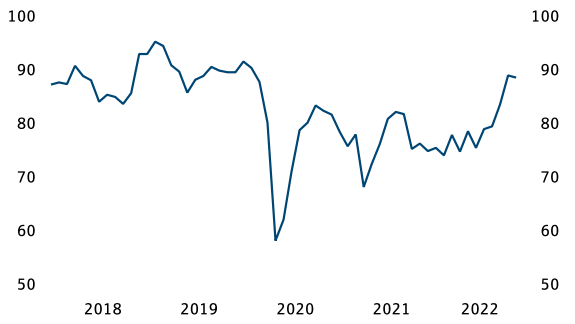
Brazil's new President Luiz Inácio Lula da Silva, who had previously held office from 2003 to 2010, will have to work with a Congress dominated by the conservative opposition for the next four years. Unlike his predecessor, the socialist has a penchant for **state intervention in the economy** and wants to abolish the market-based pricing of the state-run oil company, Petrobras. In contrast to Bolsonaro, Lula is opposed to any further privatisations.

> *"I want to prove once again that it is possible for the poorest to live well and for the economy to grow."*
> *Brazilian President Lula*

Economic growth is expected to rise to 2 % in 2023. Despite a considerably **weaker tailwind from commodity prices**, consumer sentiment, helped by falling rates of inflation, should remain buoyant. On the one hand, growth in investment is bearing the brunt of high interest rates. On the other hand, with electoral uncertainty behind them, investors now have greater clarity regarding the direction of economic policy. One factor that works in the country's favour is the diversified nature of Brazil's economy. Unlike other commodity-exporting nations, exports of goods and services amount to as little as 20 % of gross domestic product (GDP). In addition to raw materials (such as iron ore, phosphates and oil), manufacturing industry (e.g. vehicles, aviation), agriculture and tourism also play a role in Brazil.

Strong consumer sentiment

Consumer confidence index, July 2010=100



Sources: Macrobond, Helaba Research & Advisory

Sovereign debt crisis unlikely – despite high public debt

The **pressing need to consolidate public finances** will not be addressed in 2023. Had it not been for substantial revenues from commodity exports, public finances would already have deteriorated precariously in 2022 due to additional welfare spending in the run-up to the elections. Given the weaker global economy, commodity prices will return to normal in 2023. At the same time, it will be politically untenable for the government not to extend the measures to support private households beyond their expiration at the end of 2022. Overall, this means that the budget deficit in 2023, at 8 % of GDP, is likely to be even higher than in the previous year. Consequently, public debt will also continue to rise and is expected to peak in 2024 at around 90 % of GDP.

In contrast to many other emerging market countries, monetary policy in industrialised countries and the resulting increase in interest rates is **not likely to trigger a sovereign debt crisis** in Brazil. This is because less than 10 % of Brazil's debt is denominated in foreign currency and only around 15 % of government debt is held by overseas investors.

		2021	2022e	2023f	2024f
GDP, real change	% yoy	4.6	1.0	2.0	2.3
Inflation rate	% yoy	8.3	8.0	5.0	3.5
Unemployment rate	%	11.1	9.7	8.7	8.5
Budget balance	% GDP	-4.4	-6.2	-8.1	-7.0

Sources: Macrobond, Helaba Research & Advisory

The central bank was finally able to arrest the upward trend in prices after a series of increases in the key interest rate. In 2023, **inflation will gradually decline** and settle at a level of around 5 % on average for the year. Should the economic situation deteriorate markedly, it is therefore in a position to reduce rates further as a means of stimulating the economy.

Patrick Heinisch



Negative scenario: Plunge (30 %)

On a ridge walk across unfamiliar terrain in limited visibility, plunging over the edge is an ever-present risk. Obviously, the stumbling that is our baseline scenario is not the worst possible outcome on this mountain hike. But the dangers lurking along the global economy's path have rarely been as dire as they are in 2023. Many of them are related to the geopolitical situation and energy. In our negative scenario, inflation features more prominently than it did in the past.

As is all too often the case, the factors that push the economy over the edge could come from all manner of directions – including from entirely unexpected quarters. An **escalation in geopolitical tensions** is a particular focus in 2023. Even in the absence of a military worst-case scenario, the Ukraine conflict is on the brink of intensifying, which would have a commensurate impact on financial markets and economic sentiment in Germany and the West. Moreover, the difficulties industrialised countries face in rapidly extricating themselves from the Russian economy underscore the infinitely greater challenges that would arise if an increasingly belligerent **China** were to adopt a similar foreign policy stance.

The **pandemic** and its knock-on effects remain potential sources of downside risk as higher rates of sick leave may slow the economy, even without any further lockdowns. In addition, disruptions to supply chains and other bottlenecks are turning out to be tougher nuts to crack than expected. Furthermore, the interest rate shock of 2022 and the strong dollar constitute the elements of an **emerging market crisis**; though, in the current environment, commodity exporters and buyers of cheap Russian commodities are in a stronger position than importers of commodities participating in the embargo.

Heading for a global recession

Number of countries with manufacturing PMIs above 50 (out of 27)



Sources: Macrobond, Helaba Research & Advisory

The first step towards deindustrialisation?

A shortage of natural gas is a serious threat, especially for the German economy, although its immediate price impact is likely to be mitigated by large-scale government intervention. Production stoppages because of energy rationing and a loss of competitiveness, in particular for energy-intensive sectors, leads in some cases to an exodus of manufacturing capacity to cheaper overseas locations. There is room for debate as to whether this would trigger a process of **deindustrialisation**, particularly since it is unclear how keen policymakers are on retaining energy-intensive and "dirty" production processes anyway.

> *„Men do not stumble over mountains but over molehills."*
> *Confucius*

Spanning "**protective shields**" for everyone is the new craze and, if in doubt, governments simply borrow more. But this paradigm will hit the buffers when cyclically driven fiscal headwinds, increased military spending, the soaring cost of decarbonisation and rising demographic pressure on the pension system converge.

This will fuel the drive **towards fiscal union** in the EU while potentially leading to conflicts with central banks. The latter are caught in a Catch-22 position: should they fight inflation or support the shrinking economy with more liquidity and make it easier for governments to run up more debt? That will limit the scope for monetary policy easing.

It is certainly true that regulatory reforms have made the financial system more resilient to the impending challenges. Moreover, from previous experience, the effects of interest rate shocks are well understood. However, the financial sector may have forgotten past lessons learned and there are many new players on financial markets. Therefore, serious problems for financial stability emerge in our negative scenario, amounting to a "**stress test for the stress tests**".

Overview of forecasts in our negative scenario

The economies of industrialised countries contract sharply and there is a sizeable jump in unemployment. The crisis hits Europe particularly hard, while leaving the United States, as a net energy exporter, and China, as a beneficiary of cheap Russian commodity imports, less severely affected. Both Germany and the euro zone as a whole are plunged into a **deep recession**.

The picture varies from one region to another, especially as far as **inflation** is concerned. While Europe experiences a gas shortage, the downturn in the economy causes the price on the global oil market to fall, providing some relief. This has a stronger impact in the US than in Europe, which is why inflation in the euro zone initially remains high even in our negative scenario. However, the dramatic economic slump eventually drives inflation down on this side of the Atlantic, too.

Recession prompts **central banks** to do a volte-face and reduce rates again, albeit not to levels seen in 2020/2021. Given still high rates of inflation in 2023, especially in the euro zone, a resumption of asset purchase programmes would be problematic.

On the **bond markets**, the policy reversal by central banks leads to a significant fall in yields. However, they do not return to negative territory. This move is supported by a flight into supposedly safe havens and declining long-term inflation expectations. In this scenario, 10-year German Bunds trade at around 0.75 % at the end of 2023.

Due to the weak economy, default rates among **corporates** rise sharply and lead to a steep rise in risk premiums. The increase in credit defaults weighs on banks' profits and cannot be compensated for by higher interest income.

As safe-haven assets, **covered bonds** benefit from growing risk aversion but there is greater differentiation among issuers and bond maturities.

With familiar headwinds persisting and even worsening in 2023, there is a marked deterioration in corporate earnings. Risk aversion among investors rises further, putting additional pressure on valuations. **Equities** continue their downward trend, with the DAX temporarily falling to around 10,000 points.

> *„Our nature lies in movement; complete calm is death."*
> *Blaise Pascal, French mathematician and philosopher*

There is a substantial correction on the **real estate market**, which not only affects commercial segments of the market but also triggers a sharp decline in residential property prices. Interest rate cuts by central banks do not provide enough short-term relief as the recessionary environment prompts real estate lenders to adopt more conservative lending policies.

As a crisis hedge, **gold** enjoys a renaissance. The precious metal should easily beat previous highs as a safe-haven asset and soar towards the 3,000 US dollar per troy ounce mark.

The **US dollar** remains a highly sought-after safe-haven currency. Currency markets reflect the greater impact of the crisis on Europe. The EUR/USD exchange rate falls as low as 0.90.

Patrick Franke



Positive scenario: Family hike (10 %)

A hike may turn out to be stress-free and fun, despite challenging terrain and less-than-ideal weather – provided all members of the party are in the right mood. In 2023, as the weather forecast does not hold out much hope for a leisurely stroll, a lot depends on whether policymakers and business leaders are willing to cooperate. If everything goes according to plan, in the end the whole party will make it safely back down into the valley.

Our alternative scenarios are normally based on a weaker (or, indeed, stronger) cyclical picture than in the baseline scenario. As the latter features a recession in 2023, it is much easier to envisage **positive surprises**. However, it is more difficult to frame a suitable narrative for this case, given the multiple negative factors the world is currently faced with. These cannot be ignored and are extremely unlikely to simply evaporate of their own accord.

For this reason, a decrease in **geopolitical tensions** would appear to be a prerequisite for this year's positive scenario. For example, this may involve a ceasefire in Ukraine followed by negotiations, which would reduce the risk of a further escalation in the conflict. As a result, risk premiums on financial markets would fall – even if there will be no going back to the status quo ante in the relationship between the West and Russia. Any remaining gaps in European energy supplies can be swiftly plugged by new sources, both from fossil fuels and renewables. In a scenario like this, commodity prices, particularly for natural gas, will drop significantly.



A rapprochement with China is also a conceivable prospect. There is ample scope for better relations with the West, without unrealistic assumptions of a diplomatic love fest. A quick and lasting solution to **supply chain problems** will provide an added boost.

Less pressure on central banks to act

An environment like this will **alleviate some of the inflation pressure**, at least in the short term. Mirroring its current impact, the damping effect will be more noticeable in Europe than in the United States. Lower inflation will support the economy thanks to higher real incomes while – and this is the crucial point – allowing central banks to proceed somewhat more cautiously in tightening monetary policy. In this scenario, there will be no need for a significantly restrictive monetary policy.

> *"If you want to walk fast, walk alone,*
> *but if you want to walk far, walk together."*
> *Ratan Tata, Indian industrialist*

A stronger economy generates more tax revenue for governments and lowers welfare expenditure, creating additional scope for fiscal policy measures. It would also lighten the load of the substantial levels of **public debt**.

Recently, politicians and bureaucrats have been preoccupied with emergency plans for energy security. In this scenario, it will be possible to **shift the focus back to the energy transition**, which had been relegated to the sidelines – particularly in Europe – since Russia's attack on Ukraine. Closer cooperation with China will also have a positive impact on this issue by improving the availability of low-cost technologies and the required raw materials.

Overview of forecasts in our positive scenario

It is entirely reasonable to envisage higher **growth rates** than in the baseline scenario, partly because the recovery from the pandemic is still incomplete in some sectors and with supply bottlenecks continuing to weigh on the economy. What is more, this higher growth will not even necessarily have an immediate inflationary impact if disruptions to logistics, on labour markets and in manufacturing industries are rapidly resolved.

Nevertheless, our positive scenario assumes that stronger demand over the course of 2023 gradually drives up inflation, to some extent due to higher global oil prices. That is why the outlook for **inflation** here is both complex and regionally uneven. Headline inflation rates are likely to remain significantly elevated by historical standards, both in the euro zone and the United States.

Against this backdrop, **central banks** react to a short-term easing in inflation pressures by pursuing a less aggressive policy of monetary tightening. Inflation rates are not expected to be higher than in our baseline scenario until the second half of the year, signalling the need for additional rate hikes. By the end of 2023, however, key interest rates at the ECB and the Fed should still be marginally lower than in our baseline scenario.

Bond markets initially adjust to a less restrictive stance of monetary policy, which helps to ensure prices remain relatively stable for a sustained period. However, bond yields are likely to rise during the second half of the year as expectations of interest rate hikes increase again. In this scenario, the yield on 10-year German Bunds stands at around 2.5 % at the end of 2023.

The more benign macroeconomic situation boosts earnings of **corporates** and facilitates a sharper drop in risk premiums. Despite this, spreads are likely to stay above their 2021 level. In this changed interest rate environment, **banks** see a considerable rise in interest income while ratios of non-performing loans remain encouragingly low.

For **covered bonds**, the impact of risk factors and uncertainties fades more quickly than expected. As a consequence, risk premiums fall and spreads tighten. The declining appeal of covered bonds prompts some investors to look for higher-yield alternatives.

The economic recovery leads to a rapid surge in corporate profits. At the same time, existing valuation potential for **equities** will be fully exhausted. With a significant rise in investors' risk appetite, the DAX breaches the 17,500-point mark by the end of 2023.

> *"Those who remove mountains begin by carrying away small stones."*
> *Chinese proverb*

Real estate is a beneficiary of the upswing in the economy. However, despite the slower pace of monetary tightening, higher interest rates still weigh on this asset class. The residential segment, in particular, manages to avoid a correction. The more favourable environment makes stable real estate prices the likeliest prospect.

In a climate of greater risk appetite, **gold** becomes less attractive in relation to other asset classes. Thanks to the existing inflationary environment, however, the precious metal only falls to 1,500 US dollar per troy ounce.

The easing of geopolitical tensions combined with a more optimistic outlook for energy and the economy will show up on **currency markets**. Risk premiums for the euro fall and the funds are once again able to flow out of the safe-haven US dollar. The EUR/USD exchange rate rises to 1.20.

Patrick Franke

Gross domestic product and inflation

	Gross domestic product Real change, % yoy				Consumer prices Change, % yoy			
	2021	2022e	2023f	2024f	2021	2022e	2023f	2024f
Euro area	5.3	3.1	0.2	1.4	2.6	8.2	5.3	3.5
Germany	2.6	1.5	-0.6	1.3	3.1	8.0	6.0	3.5
France	6.8	2.5	0.5	1.5	2.1	5.7	3.8	3.0
Italy	6.7	3.3	0.2	1.7	1.9	7.8	4.3	3.0
Spain	5.5	4.4	1.0	2.0	3.0	8.8	4.3	3.5
Netherlands	4.9	4.3	-0.3	1.9	2.8	12.5	11.0	5.0
Austria	4.7	4.2	0.7	2.3	2.8	8.3	6.0	3.3
Sweden	4.8	2.3	0.2	1.2	2.2	8.4	8.0	2.2
Poland	6.7	3.6	1.0	3.0	5.1	13.9	10.0	4.2
Czech Republic	3.5	2.1	0.6	2.7	3.8	16.0	9.4	3.0
Hungary	7.1	4.7	0.8	3.3	5.1	13.0	11.5	3.5
United Kingdom	7.5	4.4	-1.0	1.5	2.6	9.0	6.5	3.7
Switzerland	4.2	2.3	1.0	1.9	0.6	2.9	2.0	1.3
USA	5.9	1.8	0.5	1.8	4.7	8.1	4.0	2.5
Japan	1.7	1.3	0.7	1.0	-0.2	2.5	1.5	1.0
Asia ex Japan	6.9	4.0	4.7	4.5	2.4	3.9	3.1	2.8
China	8.2	3.5	5.0	5.0	0.9	2.5	2.5	2.5
India*	8.9	6.7	5.2	4.8	5.1	6.9	5.0	4.5
Russia	4.7	-9.0	0.0	2.0	6.7	16.0	9.0	3.6
Turkey	11.1	3.3	3.5	3.5	19.6	45.0	18.0	11.2
Latin America**	7.0	2.4	2.3	2.7	10.3	13.1	8.7	5.6
Brazil	4.6	1.0	2.0	2.3	8.3	8.0	5.0	3.5
World	6.2	2.8	2.6	3.1	3.8	7.1	4.6	3.1

*India: Financial Year; ** Latin America ex Venezuela due to hyperinflation; f=forecast, e=estimate; GDP growth working-day adjusted if available

Sources: Macrobond, Refinitiv, Helaba Research & Advisory



Financial markets forecasts

	Change from end of year	latest*	Helaba forecast for end of period... Q1/2023	Q2/2023	Q3/2023	Q4/2023
Interest rates	basis points	%				
ECB refinancing rate	200	2.00	2.75	2.75	2.75	2.75
ECB deposit rate	200	1.50	2.25	2.25	2.25	2.25
Overnight rate €STR	199	1.40	2.20	2.25	2.25	2.25
3M Euribor	237	1.80	2.60	2.70	2.70	2.70
6M Euribor	285	2.30	2.70	2.75	2.75	2.75
2y Bunds	279	2.17	2.00	2.00	2.00	2.00
5y Bunds	252	2.07	2.15	2.20	2.15	2.15
10y Bunds	229	2.11	2.30	2.40	2.30	2.30
2y swap rate	317	2.88	2.85	2.75	2.75	2.70
5y swap rate	274	2.76	3.00	3.00	2.95	2.90
10y swap rate	251	2.81	3.20	3.25	3.10	3.10
20y swap rate	215	2.70	2.85	2.95	2.80	2.80
30y swap rate	186	2.33	2.85	2.95	2.80	2.80
Fed funds target rate	375	3.88	4.38	4.38	4.38	4.38
10y Treasuries	226	3.77	3.80	3.90	3.80	3.70
Equities	in local currency, %	index				
DAX	-9.5	14,379	14,000	15,000	15,500	16,000
Euro Stoxx 50	-8.9	3,915	3,850	4,100	4,150	4,200
Dow Jones	-7.6	33,593	34,000	36,000	36,500	37,000
S&P 500	-16.2	3,992	4,250	4,500	4,650	4,800
Nikkei 225	-2.8	27,990	30,000	32,000	33,000	33,500
Gold / crude oil	%					
Gold €/oz	6.8	1,719	1,714	1,714	1,727	1,727
Gold $/oz	-2.7	1,779	1,800	1,800	1,900	1,900
Brent crude $/barrel	20.7	94	83	85	87	89
Currencies	vs. euro, %	exchange rate				
US dollar	9.9	1.03	1.05	1.05	1.10	1.10
Japanese yen	-9.2	144	145	142	142	140
British pound	-3.5	0.87	0.88	0.87	0.85	0.85
Swiss franc	6.2	0.98	1.00	1.02	1.04	1.05

*15/11/2022

Sources: Bloomberg, Helaba Research & Advisory

Selected energy indicators

	Share of global GHG emissions, % 2018	GHG emissions per capita, in metric tons of CO_2, 2018	Share of renewable energy, % of primary energy supply, 2019	Land and marine protected areas, % of total surface area, 2018	Corruption Perception Index 2020	Working age population (15-64), share in %, 2020	National debt, % of GDP, 2020	Public spending on education, % of GDP, 2018
European Union*	6.8	7.5	14.2	23.1	-	64.1	90.1	-
Germany	1.6	9.4	14.6	38.8	80	64.4	69.1	3.7
France	0.7	5.4	10.7	33.2	69	61.6	115.1	4.5
Italy	0.8	6.4	18.2	13.4	53	63.7	155.8	3.5
Spain	0.6	6.7	14.7	15.0	62	65.6	119.9	3.4
Netherlands	0.4	10.5	7.2	21.2	82	64.3	52.5	4.2
Austria	0.1	7.7	30.2	28.4	76	66.4	83.2	4.4
Sweden	0.1	3.0	40.8	15.0	85	62.0	37.3	5.3
Poland	0.7	9.4	9.3	38.1	56	66.0	57.5	3.7
Czech Republic	0.2	11.0	10.7	22.2	54	64.1	37.8	3.6
Hungary	0.1	6.4	10.3	22.6	44	65.4	80.4	3.3
United Kingdom	0.9	6.6	12.5	28.8	77	63.7	104.5	3.9
Switzerland**	0.1	5.1	22.5	9.7	85	65.9	42.4	4.4
USA	11.8	17.7	7.9	26.3	67	65.0	133.9	4.1
Japan	2.4	9.1	6.2	10.0	74	59.2	254.1	2.8
China***	23.9	8.4	9.2	14.6	42	70.3	66.3	-
India***	6.8	2.5	22.6	3.5	40	67.3	89.6	-
Russia***	4.1	13.8	2.6	7.6	30	66.1	19.3	2.9
Turkey	1.0	5.8	15.9	0.2	40	67.1	39.8	3.7
Brasil	2.9	6.8	45.8	28.6	38	67.0	98.9	5.0
World***	100.0	6.5	13.5	14.3	-	65.2	-	-

*EU27, exception: protected areas (EU28); debt based on Eurostat figures, not IMF; renewable energy: as of 2018

**spending on education: as of 2017 ***renewable energy: as of 2018

Sources: Climate watch, OECD, World Bank, Transparency International, IWF, Eurostat, Helaba Research & Advisory

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