Manulife Investment Management

Q1 2023 | Global Macro Outlook

The year ahead

A sneak preview

Frances Donald
Global Chief Economist
and Strategist

Sue Trinh
Co-Head, Global Macro Strategy

Alex Grassino
Co-Head, Global Macro Strategy

Eric Theoret
Global Macro Strategist

Erica Camilleri
Global Macro Analyst

Dominique Lapointe
Global Macro Strategist

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Global overview

Trends that could define 2023

As we consider the year ahead, we expect to see a game of two halves, where challenging conditions will prevail in H1 before improving through H2. The aggressive pace of monetary tightening and its associated lagged effects should drive a synchronized global growth downturn in the first half.

We expect global growth to slow materially and come in substantially lower than the below 3% threshold that the International Monetary Fund uses to define global recessions.[1] A downturn of this magnitude—excluding the COVID-19 shock and the global financial crisis—could make 2023 the worst year for global growth since the 1980s. We expect the economic slump to become more apparent in the first half of the year, with a cyclical bottom only occurring in Q2/Q3.

Our analysis shows that most advanced economies are likely to experience a recession in the year ahead. Given that the U.S. Federal Reserve (Fed) has been hiking rates at the fastest pace in decades, the U.S. economy will be facing the lingering effects of substantial policy tightening, with real rates rising while inflation eases gradually.

2022 has been a year to forget for many investors. Persistent stagflationary dynamics, continued geopolitical upheaval, and an aggressive Fed drove double-digit declines across many asset classes, and there were few places to hide.

Market's view on the probability of a global recession (%)

Source: Bloomberg, Macrobond, Manulife Investment Management, as of December 13, 2022.

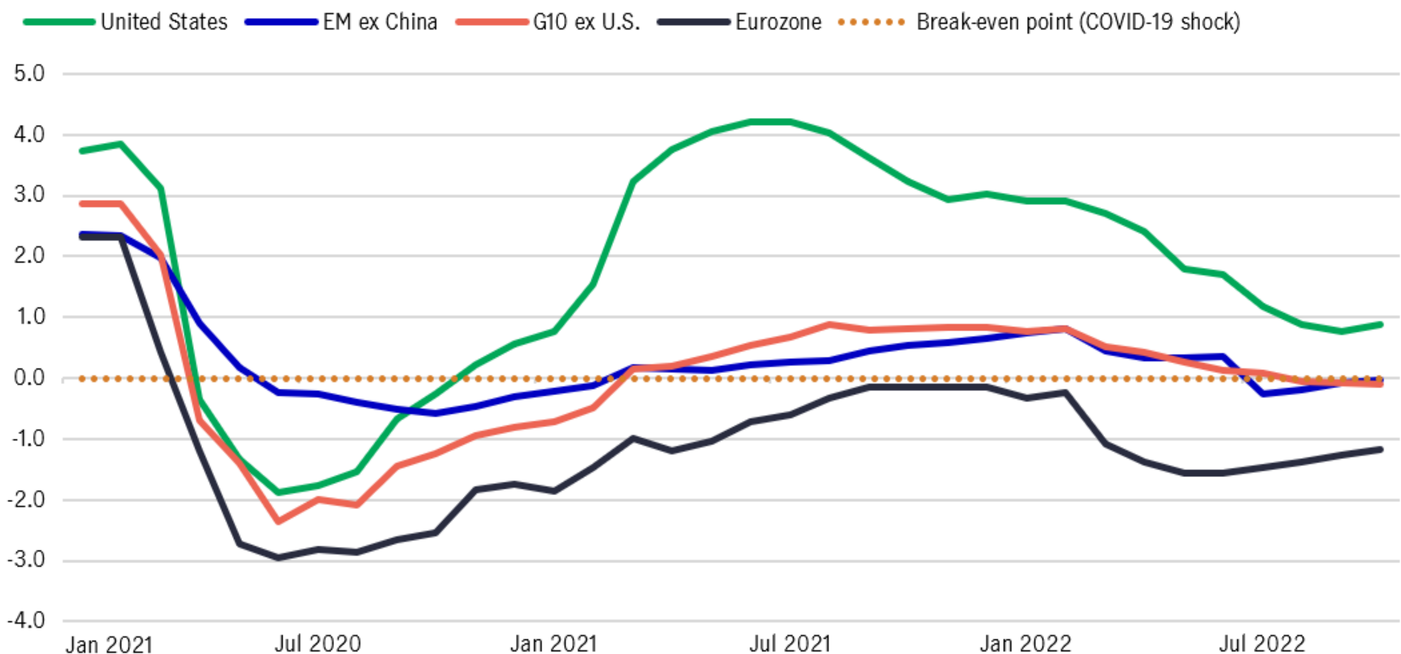
1 *Collapse and Revival: Understanding Global Recessions and Recoveries*, International Monetary Fund, 2015.

Economic weakness will be particularly pronounced in interest-rate-sensitive economies such as Canada, Australia, New Zealand, and the United Kingdom—these economies would almost certainly be confronting downside risks as a result of spillovers from their respective weaker housing markets. In Continental Europe, the growth drag will predominantly stem from particularly large negative terms-of-trade shocks.

Meanwhile, slowing final demand from advanced economies, elevated inflation, and a still-strong U.S. dollar (USD) will likely morph into material headwinds for growth in emerging markets (EM). In mainland China, a bumpy exit from zero-COVID policy, weak external demand, a still struggling property sector, and insufficient policy support look set to extend the country's below-trend GDP into 2024. That said, the prospects for the rest of Asia's economies are a little more mixed: We expect weak foreign demand to weigh on export growth, but North Asia is particularly vulnerable in light of a likely inventory overhang. On the other hand, weakness in ASEAN countries will likely be cushioned by a strong reopening bounce and relatively healthy household balance sheets.

Amid a macro backdrop characterized by elevated global inflation, uncertainty over when Fed rates might peak, and rising odds of a global recession, the first half of 2023 could bear witness to a series of sharper—and longer—bouts of market volatility. Thankfully, the picture does brighten slightly in H2, during which these headwinds are likely to moderate, ushering in more conducive conditions for financial markets.

Cumulative forecast revisions to GDP growth, 2020–2023



Source: Bloomberg, Manulife Investment Management, as of November 26, 2022. EM refers to emerging markets. In this chart, EM represents the combined reading of the following economies: Argentina, Brazil, Chile, China, Colombia, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, the Philippines, Poland, Russia, South Africa, and Turkey. G10 refers to the group of 11 leading industrial countries: Belgium, Canada, France, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

Our base-case expectations

Our base case is that the looming negative demand shock is sufficient to see growth concerns overtake fears about the inflationary backdrop, a development that could pave the path to a dovish policy pivot among central banks, leading to monetary easing in Q4. This is consistent with current market pricing and the historical tendency over the past five decades, where rapid and substantial rate hikes have tightened financial conditions so quickly that the subsequent growth slowdown prompted a sharp turnaround in the Fed cycle from tightening to easing.

While our forecast for the first half of 2023 may seem bearish, it's always helpful to remember that periods of volatility often create opportunities. It's also a period in which active managers can flex their skills and extract alpha. Crucially, there's light at the end of the tunnel, as we expect trading conditions to improve in H2.

Three key risks to our baseline assumptions

1 **Timing of the stagflation trough: stagflationary dynamics may extend into late 2023/early 2024**

The impact that monetary policy has on the real economy typically isn't easily observable until 12 to 18 months later. We're wary that the transmission of the current global tightening cycle has barely begun; historically, the slowdown in growth becomes manifest once the tightening cycle has *ended*. Looking back to the year just past, global financial conditions only moved into restrictive territory in March 2022, a threshold that the United States crossed six months later. Put differently, it could be some time before we get past the most painful part. It's also worth noting that the nature of the current cycle—in which a large component of inflation is supply driven and becoming geopolitically entrenched—is also very different from past cycles. The supply/demand balance remains tight, and commodity constraints are more binding than usual. Crucially, China's reopening may bring commodity constraints back into focus and complicate the monetary policy picture for developed markets.

The rebuilding of commodity reserves such as oil (e.g., the Strategic Petroleum Reserve in the U.S.), gas (as Europe refills its storage after the winter), grains (India may start rebuilding its food grain buffers), strategic commodities (e.g., high-end semiconductors and critical commodities such as hydrocarbons), and the volume of metals needed in the green transition could well push commodity prices higher. In terms of monetary policy, although the Fed is set to raise interest rates at a slower pace, Fed Chair Jerome Powell noted that the end point for the central bank's current tightening cycle may result in a higher terminal rate than previously expected. Meanwhile, several Fed speakers have signaled that rates could remain at an elevated level for a longer period of time before they could even begin to consider easing.

"We're wary that the transmission of the current global tightening cycle has barely begun; historically, the slowdown in growth becomes manifest once the tightening cycle has *ended*."

Key signposts to monitor

- Global inflation
- Fed policy and statements
- Evolution of China's zero-COVID policy
- Pace of inventory adjustment

2 Mainland China's zero-COVID controls

We maintain our view that the path to reopening will gain significant momentum only after the National Party Congress in March 2023. The recent call for a whole society push to encourage the elderly to get vaccinated is an important shift, although it remains to be seen whether persuasion alone will increase vaccine take-up or if the rollout will proceed as quickly as planned.

Key signposts to monitor

- Vaccination/fatality rate
- Healthcare infrastructure capacity
- Announcement of a centrally planned top-down structured reopening

3 USD strength: too early to call a peak

A weaker USD is typically associated with an improved global growth outlook and a risk-on environment for risk markets; the converse is also true. Sustained USD depreciation would require global economic growth outside of the United States to outstrip U.S. growth and for interest-rate differentials between the United States and the rest of the world to narrow; however, neither dynamic appears likely for the time being. Additional tailwinds for the USD could arise from EM central banks replenishing their foreign exchange (FX) reserve buffers.

Key signposts to monitor

- U.S. growth
- Interest-rate differentials relative to the rest of the world

Continued U.S. dollar strength could negatively affect global growth prospects

Source: Macrobond, Manulife Investment Management, as of December 13, 2022. The gray area represents recession. It is not possible to invest directly in an index.

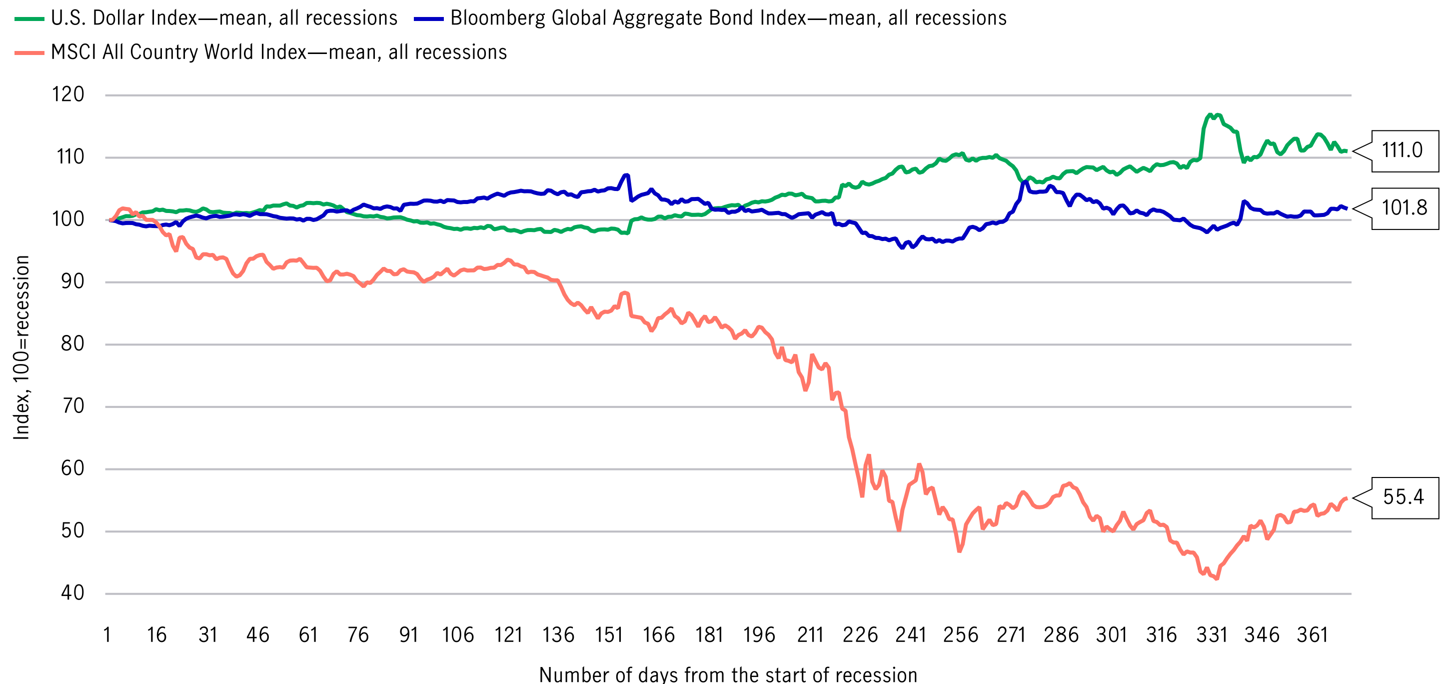
Speculation about a possible global recession mounts

While the market consensus on a global recession has been rising in recent months, it has yet to tip into consensus view, with a probability of below 50%. Notably, the market remains skeptical about the likelihood of a U.S. recession. When we add an additional screen in our analysis of risk asset performance during U.S. recessions, we find that global equities tend not to hit bottom before a recession has begun. The argument that global yields have peaked before the official onset of a U.S. recession, however, is a little more compelling. In regard to the USD, a U.S. recession isn't necessarily USD negative unless the country's economy is leading the world into a global recession. This is the case even when the Fed is cutting more aggressively than other central banks (due to the USD's safe haven status).

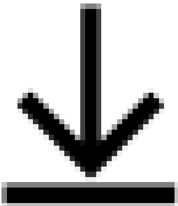
> "The key, as always, is to remain cautious and steer clear of confirmation biases and groupthink."

While it might be psychologically inviting to believe that the worst of the market upheavals is over, our analysis suggests otherwise. Policy takes time to work its way through to the real economy, and there's no reason to assume that things could be different this time. That said, experienced investors understand instinctively that market swings can bring about compelling opportunities and that sharp market movements are typically smoothed out over a longer investment horizon. The key, as always, is to remain cautious and steer clear of confirmation biases and groupthink. The way we see it, things will get better, and positive change is on the horizon, but we're just not quite there yet.

How equities, bonds, and the USD behave during U.S. recessions



Source: Macrobond, Manulife Investment Management, as of December 13, 2022. USD refers to the U.S. dollar. It is not possible to invest directly in an index.



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