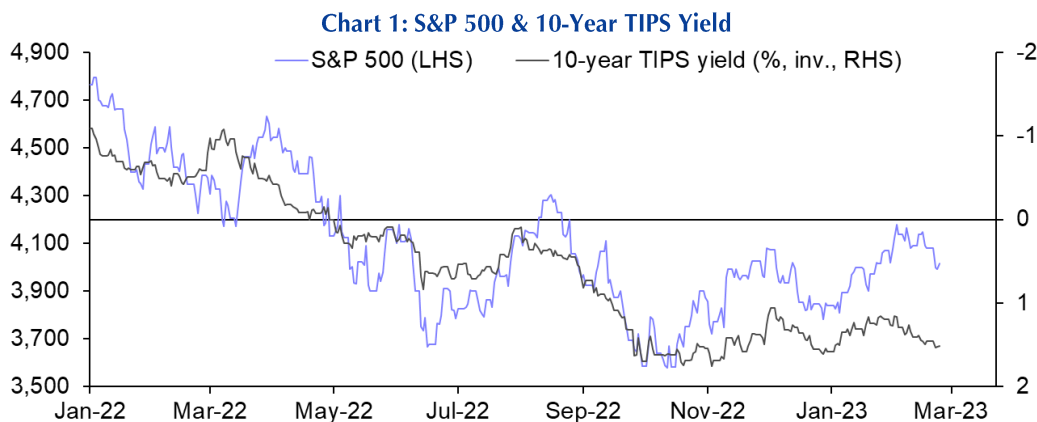




DM MARKETS CHART BOOK

Recession still a threat to risky assets in our view

- **Investors seem to have become more worried about inflation recently, with evidence that the global economy is holding up better than expected suggesting underlying price pressures might prove more persistent than hoped. That’s taken a toll on both “safe” and “risky” assets. We are still confident that inflation will fall, at least in the US. But while that might help restart the bond market rally, we don’t think it would help risky assets much if, as we expect, it came alongside much weaker economic activity.**
- **Inflation seems to be back on investors’ minds.** The 1-year US CPI inflation swap rate, which had fallen below 2% in mid-January, has risen sharply in recent weeks and is now around 3%. That probably reflects the slew of generally positive economic news which has suggested that, even if manufacturing sectors are struggling, the overall economy is probably holding up better than had been expected. Investors had seemingly been banking on some economic slowdown to cool underlying price pressures; without that on the cards the Fed may have to hike a lot more, and maybe hold rates “higher for longer”.
- **That’s taken a toll on both safe and risky assets** (see Chart 1), which had received some relief earlier in the year as inflation worries faded.
- **For our part, while we’ve revised up our inflation projections a bit we’re still confident that it will fall over the remainder of this year. But that’s partly because we think the US economy is still headed for a recession.** After all, leading indicators still seem consistent with a contraction later this year. (See [here](#).)
- **We think that will enable the Fed to “pivot” much more quickly than now seems to be discounted in financial markets. That, in our view, will restart the rally in sovereign bonds;** we forecast the 10-year Treasury yield, for example, to fall quite a bit this year. **But it would probably be bad news for risky assets;** after all, they have typically struggled at the onset of recessions even as safe yields have fallen.
- **Monetary Policy** – DM central banks have continued to tighten policy.
- **Government Bonds** – Yields have increased in most places as expectations for policy rates have risen.
- **Corporate Bonds** – Yields have been mixed, with rising risk-free rates offset in some cases by lower spreads.
- **Equities** – Stocks have made gains in Europe but have generally fallen elsewhere.
- **Forecast Summary**



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Monetary Policy

- Monetary tightening cycles have continued this month, with the [US Fed](#), the [ECB](#) and the [Bank of England](#) all having hiked rates at the beginning of February. Rates have also risen in [Australia](#) and [New Zealand](#). And Sweden's Riksbank hiked its rate at the first meeting headed by its new governor, Erik Thedéen, and revised up its interest rate projections. While this prompted investors to revise up their own policy rate expectations, we still think the hiking cycle is close to an end and predict rate cuts to begin earlier than in the euro-zone (2), partly because we expect the Swedish economy is headed for a deeper recession.
- Meanwhile, Kazuo Ueda's formal nomination as the next Bank of Japan (BoJ) governor this month does not change our view that Yield Curve Control is on its way out, as the BoJ's bond purchases become unsustainable. But we still think that short-term interest rates will be unchanged this year.
- Otherwise, investors have generally revised up their expectations for policy rate hikes, on the back of stronger-than-expected economic data (3 & 4). That has reversed the declines in January in expectations for the peak, end-2023 and end-2024 policy rates in major markets (5). It has also widened the gap between our forecasts and those implied by OIS rates over the rest of this year and to end-2024. We now forecast significantly lower policy rates than those implied by OIS markets in most major economies (6 & 7).

Chart 2: Riksbank Repo Rate (%)

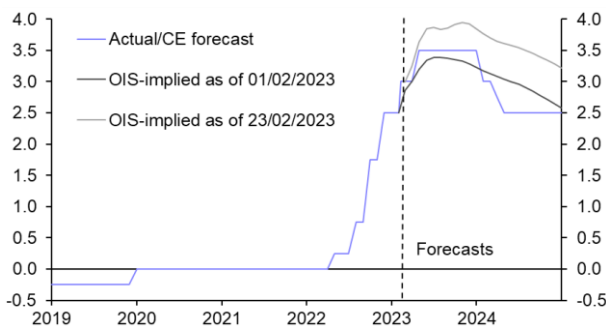


Chart 3: OIS-Implied Policy Rates In 1 Year (%)

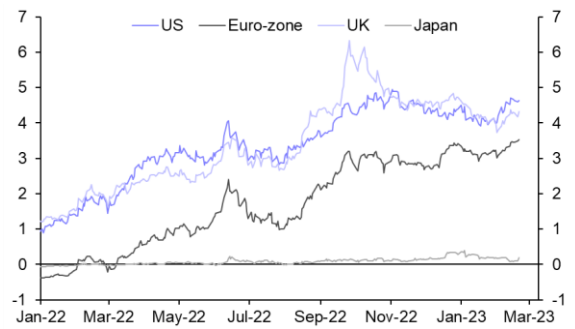


Chart 4: OIS-Implied Policy Rates In 1 Year (%)

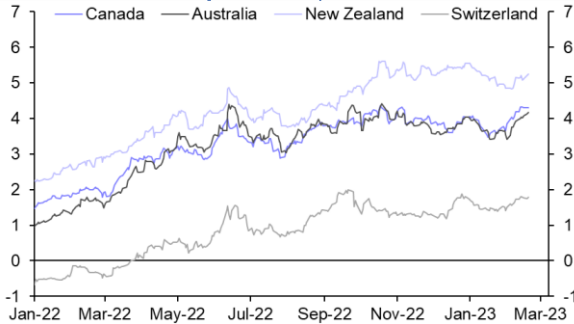


Chart 5: Changes In OIS-Implied Forward Rates (bp)

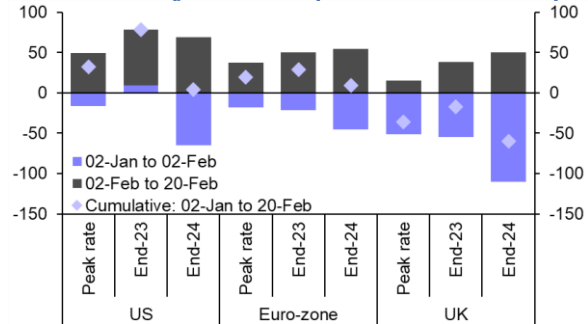


Chart 6: End-2023 CE Policy Rate Forecasts Less OIS-Implied Rates (bp)

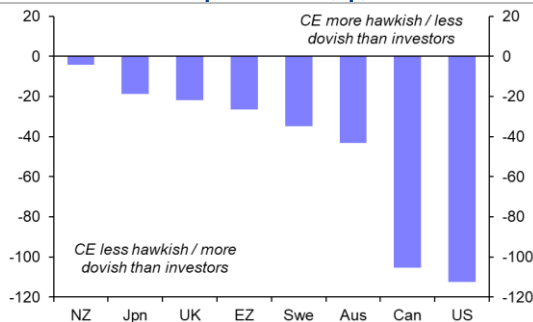
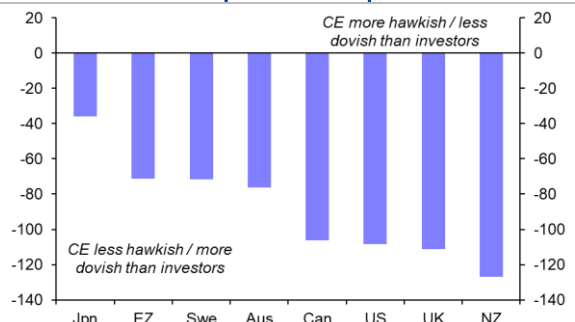


Chart 7: End-2024 CE Policy Rate Forecasts Less OIS-Implied Rates (bp)



Sources: Bloomberg, Refinitiv, Capital Economics



Government Bonds

- Despite having fallen early in the month after the Fed, ECB and BoE meetings, government bond yields have risen sharply in most developed market economies on net since the end of January (**8 – 10**), as investors have revised up their expectations for rate hikes. The 10-year Bund yield, for example, fell ~20bp in the first two days of February, but has since risen ~50bp above that level. 10-year yields have now retraced much of their falls of earlier in the year, and entirely retraced them in some places (**11**).
- The rise in yields generally reflected both higher inflation compensation and rising real yields (**12**), with investors seemingly interpreting stronger-than-expected economic data in several DMs as a sign that inflation will be harder to rein in than had been anticipated.
- We still think recessions are on the cards in the US and other advanced economies and that, partly as a result, inflation will fall faster than investors expect. That, we suspect, will lead central banks to turn increasingly dovish and cut rates much more quickly than now seems to be discounted in markets. As such, we forecast most long-dated government bond yields to fall, in general, over the rest of this year (**13**).

Chart 8: 10-Year Government Bond Yields (%)

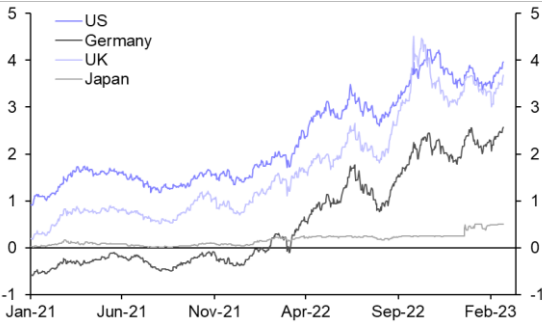


Chart 9: 10-Year Government Bond Yields (%)

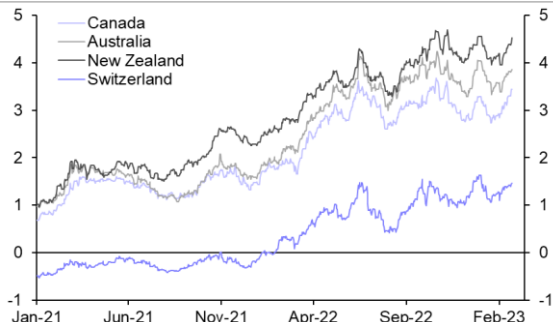


Chart 10: 10-Year Yield Spreads To German Bunds (bp)

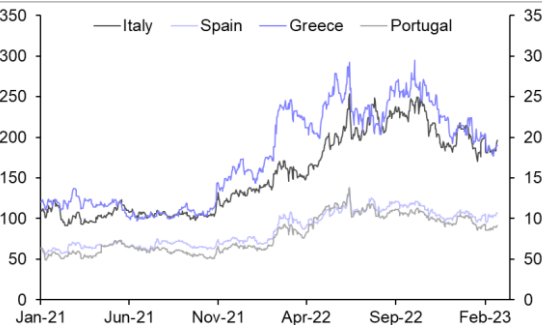


Chart 11: Year-To-Date Changes In 10-Year Government Bond Yields (bp)

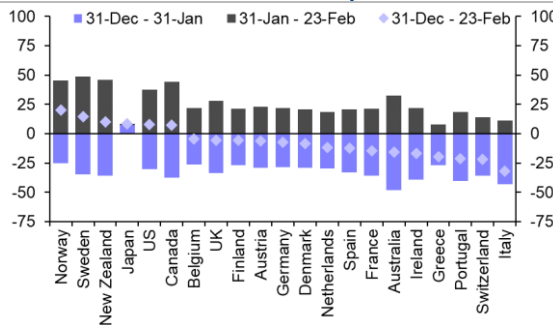


Chart 12: Estimated Decomposition Of Changes In 10-Year Government Bond Yields Since 31st January

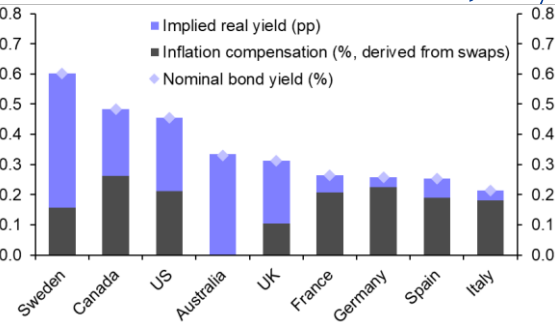
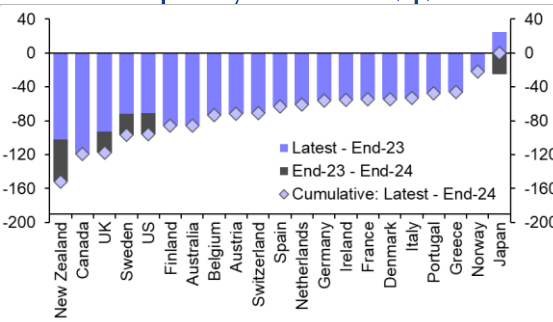


Chart 13: Changes In 10-Year Government Bond Yields Implied By CE Forecasts (bp)



Sources: Bloomberg, Refinitiv, Capital Economics



Corporate Bonds

- The yields of ICE BofA ML's indices of investment-grade (IG) corporate bonds have risen so far this month, whereas those of the high-yield (HY) corporate bond indices have been mixed (14 & 15). While "risk-free" rates have generally increased across the board, option-adjusted spreads (OAS) rose slightly in the US but fell elsewhere (16). In the case of the HY indices in the euro-zone and the UK, the fall in spreads more than offset the rise in risk-free yields. One consequence of this was that while IG spreads remain higher in the euro-zone than the US, HY spreads are now higher in the US for the first time since October 2021 (17).
- IG OAS rose in most sectors in the US, with particularly sharp increases in the spreads of the media, healthcare and transportation sectors (18). By contrast, spreads declined across most sectors in the euro-zone (19) and UK, although the falls in the latter were generally fairly small.
- We think that credit spreads may rise a little across the board if, as we expect, the US economy falls into recession this year and growth remains slow elsewhere. However, we expect risk appetite to recover towards the end of the year, as recessions come to an end and many central banks begin to cut rates. As such, we expect government bond yields to drop back over the remainder of this year and for corporate bond yields to end this year slightly below their current levels.

Chart 14: Yields Of ICE BofA ML IG Corporate Bond Indices (%)

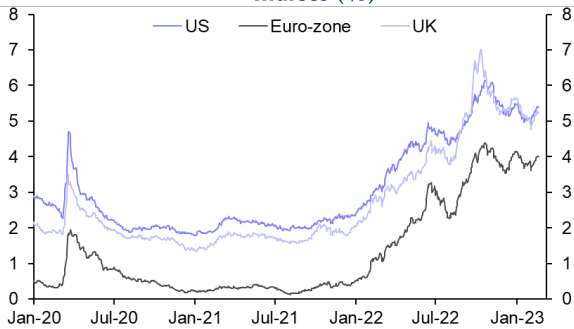


Chart 15: Yields Of ICE BofA ML HY Corporate Bond Indices (%)

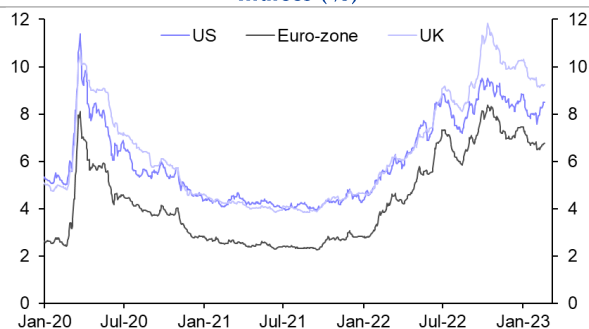


Chart 16: Decomposition Of Changes In ICE BofA ML Corporate Bond Indices Since 31st Jan. 2023 (bp)

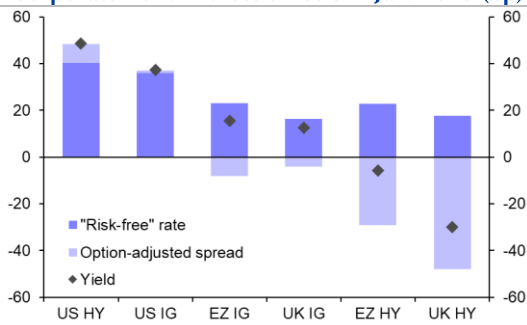


Chart 17: OAS Of ICE BofA ML EZ Corporate Bond Indices less OAS of US Indices (bp)

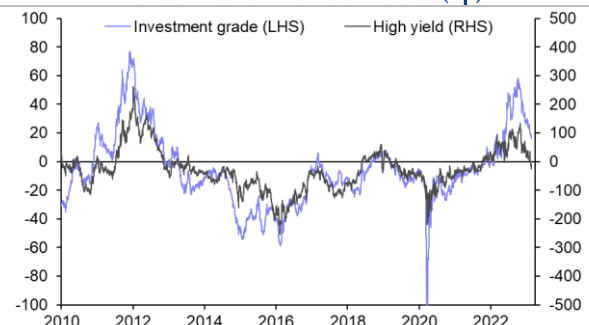


Chart 18: Changes In OAS Of ICE BofA ML US IG Corporate Bond Indices Since 31st Jan. 2023 (bp)

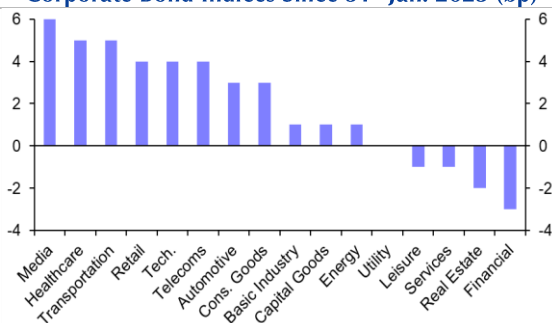
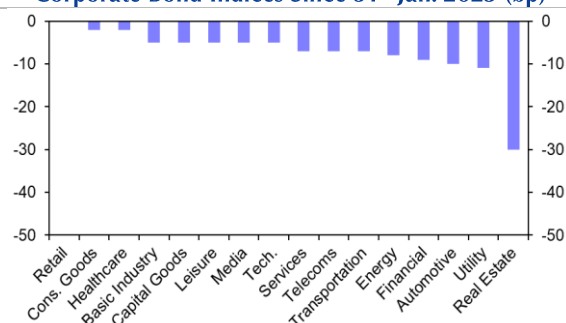


Chart 19: Changes In OAS Of ICE BofA ML EZ IG Corporate Bond Indices Since 31st Jan. 2023 (bp)



Sources: Refinitiv, Capital Economics



Equities

- DM equities have been mixed so far this month. Those in Europe have generally made decent gains, but the MSCI USA Index, for example, is slightly lower (20). The relative strength of Europe’s stock markets probably reflected further falls in natural gas prices (21), as well as evidence that the region’s economy has held up better than had been feared. Despite the gains in Europe’s equities, though, the MSCI World Index is slightly lower so far this month, due to the large weight of the USA in it (22).
- Most sectors of the market have struggled so far this month, with only the industrials, information technology and consumer staples indices having made modest gains (23). The relative resilience of the information technology sector is perhaps surprising, given it is generally seen as more rate-sensitive than others, and yields have risen (24). Meanwhile, the energy sector index has fallen the most, as the prices of energy commodities have declined (25).
- We still think equity indices will struggle in most DMs over the next couple of quarters as economic activity eventually weakens. But we think any recessions will be fairly short lived and that equities will rebound before too long; we project most major DM equity indices to finish the year higher than their current levels.

Chart 20: Changes In MSCI Country Indices Since 31st January (LC, %)

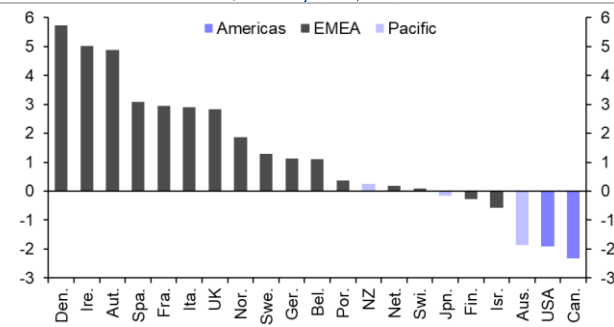


Chart 21: MSCI USA/EMU Relative Performance & Europe Natural Gas price

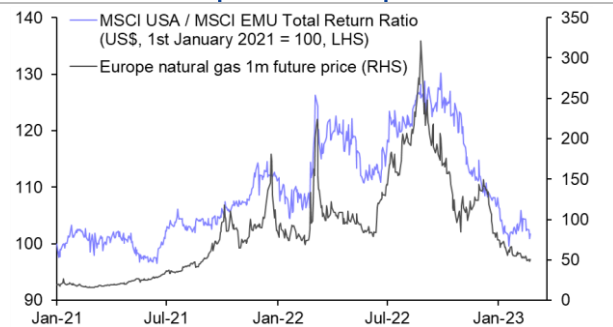


Chart 22: MSCI Equity Indices (LC, 1st Feb. 2023 = 100)

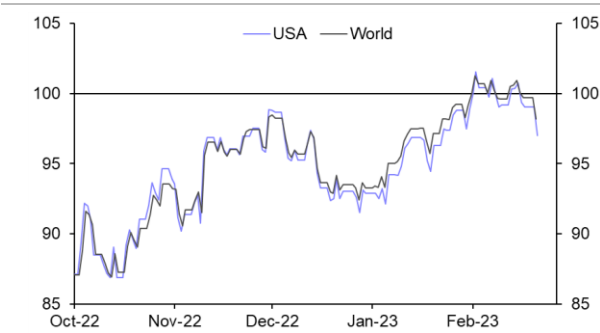


Chart 23: Changes in MSCI World Sector & Aggregate Indices Since 31st January (LC, %)

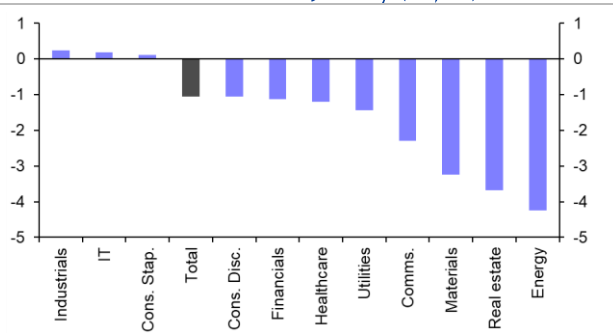


Chart 24: MSCI World Sector Index/ MSCI World Ratios & 10-Year TIPS Yield

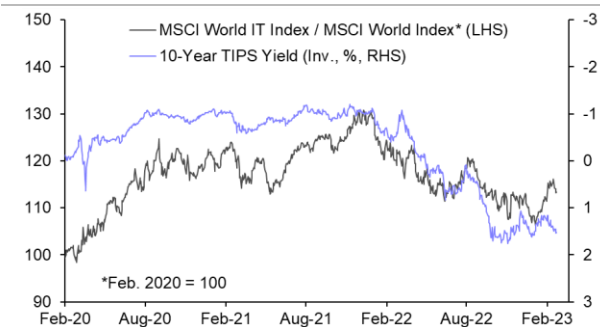
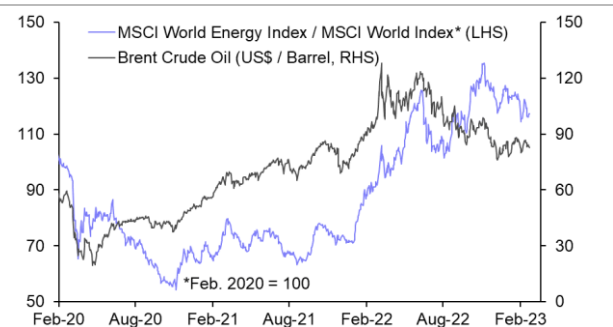


Chart 25: MSCI World Energy Sector/ MSCI World Ratio & Oil Price



Sources: Refinitiv, Capital Economics



Forecast Summary

	Forecast Summary		
	Latest (22 nd / 23 rd February)	End 2023	End 2024
Stock Market Indices (Local Currency)			
US – S&P 500	3,993	4,200	4,500
Germany – DAX 30	15,488	16,000	18,050
UK – FTSE 100	7,914	8,500	9,500
Japan – TOPIX	1,975	2,150	2,400
Canada – TSX Composite	20,175	21,200	23,500
Australia – ASX 200	7,285	7,800	8,500
10-Year Government Bond Yields (%)			
US	3.90	3.25	3.00
Germany	2.48	2.00	2.00
Italy	4.37	4.00	4.00
UK	3.59	2.75	2.50
Japan	0.50	0.75	0.50
Canada	3.35	2.25	2.25
Australia	3.89	3.00	3.00
ICE BofA ML Corporate Bond Indices – Option Adjusted Spreads (bp)			
US Investment Grade	128	140	110
Euro-zone Investment Grade	146	135	105
UK Investment Grade	167	160	125
US High Yield	441	420	400
Euro-zone High Yield	429	400	380
UK High Yield	576	610	580

Sources: Refinitiv for latest; Capital Economics for forecasts.



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