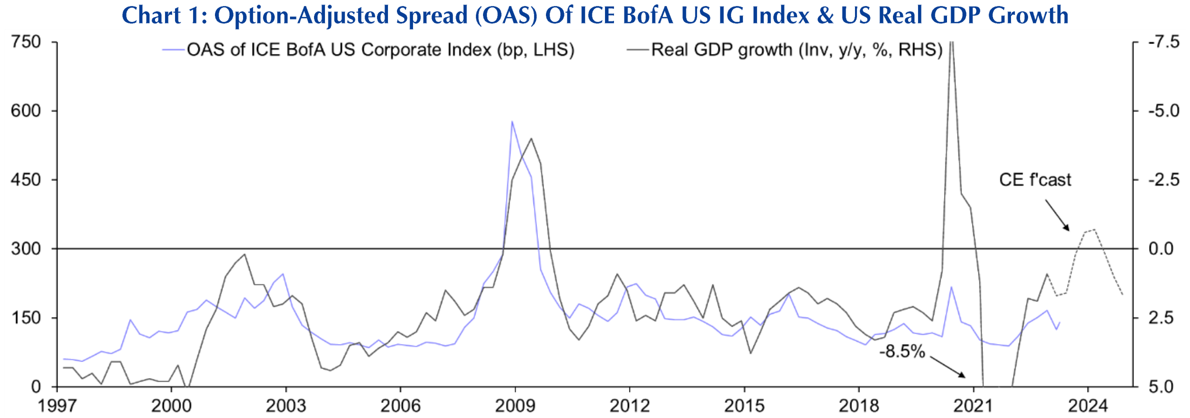
DM MARKETS CHART BOOK

We expect "risky" assets to fall later this year

- **We think disappointing global growth will be a headwind for "risky" assets in developed markets (DMs) during the second half of this year.**
- **So far, this month has been a tale of two halves**. Over the first part of the month, investors looked like they were turning increasingly optimistic about economic growth, which generally pushed up both equity prices and the yields of government bonds in DMs. Since around 18th April, however, confidence in this narrative seems to have begun to fade. The S&P 500, for example, has fallen by ~2% since then, reversing its rise from earlier in the month.
- **We think investors are still optimistic about economic growth this year**. US credit spreads, for example, are still consistent with the country's economy expanding at a decent rate this year. (See Chart 1.) And the valuation of "risky" assets isn't particularly low either; the price-to-forward earnings ratio for the S&P 500, for example, is still a little above its 10-year harmonic mean. All this is at odds with the recessions we forecast in the US and other DMs this year.
- **Admittedly, there have recently been some signs that the global economy might be holding up a bit better than we originally envisaged**. China's economy, for example, appears to have rebounded more strongly than most anticipated in the first quarter of this year. And some recent data out of the euro-zone also came in a bit stronger than expected. But we still think some pain is in store, although it might take a little longer to materialise. **For this reason, we now forecast the S&P 500 to reach a fresh cyclical low of 3,800 in the fourth quarter of 2023** (our previous forecast was a trough of 3,500 around the third quarter).
- **Monetary Policy** – DM central banks' policy reaction functions show signs of divergence.
- **Government Bonds** – Yields have generally remained lower than prior to the banking sector turmoil.
- **Corporate Bonds** – Investment-grade credit spreads have fallen, while high-yield spreads have been mixed.
- **Equities** – Stocks have fallen in the past week or so, more than offsetting gains earlier this month.
- **Forecast Summary**

Chart 1: Option-Adjusted Spread (OAS) Of ICE BofA US IG Index & US Real GDP Growth



Sources: Refinitiv, Capital Economics

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Monetary Policy

- So far, this month has been a mixed bag for central banks' policy rate decisions, with New Zealand's RBNZ and Sweden's Riksbank hiking by 50bp, while the central banks of Canada and Australia left their rates unchanged. Part of this difference is probably explained by some divergence in these central banks' policy reaction functions; in Australia, for example, policymakers appear more willing to allow a slower return of inflation to target, compared to their counterparts in New Zealand. But we doubt Australia's RBA has ended its tightening cycle just yet, and we expect the country's red hot labour market will prompt policymakers to deliver a final 25bp hike in May. And further ahead, we think the RBA will switch to cutting rates later than investors currently anticipate **(2)**.
- Taking a step back, since the start of this month, investors have generally pushed up their shorter-term expectations for policy rates, while their longer-term expectations have remained relatively unchanged and in some cases *fallen*. But rate expectations generally remain *lower* than they were in early March **(3-5)**.
- In general, we still think investors underestimate the pace of future disinflation; for this reason, we forecast rates to be a bit lower than investors anticipate in end-23 and end-24 in most DMs **(6 & 7)**.

Chart 2: RBA Cash Rate (%)

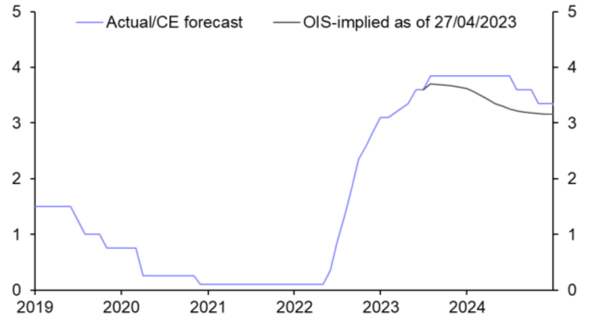


Chart 3: OIS-Implied Policy Rates (%)

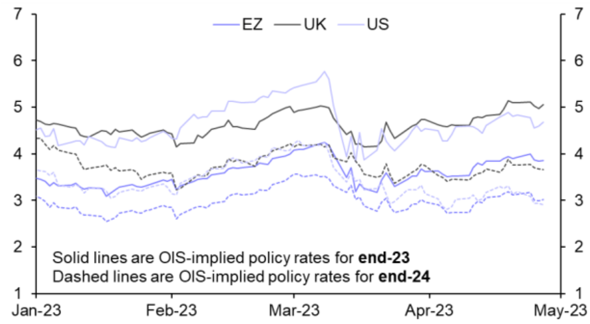


Chart 4: Changes In OIS-Implied Policy Rates For End-23 Since 8th March (bp)

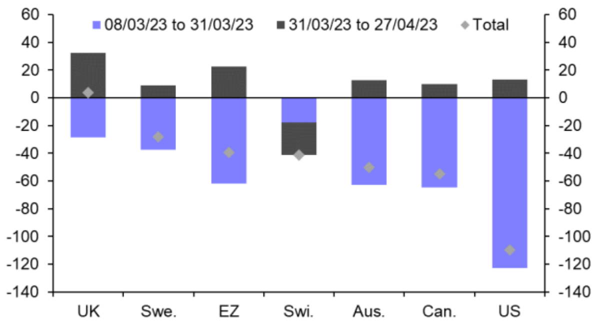


Chart 5: Changes In OIS-Implied Policy Rates For End-24 Since 8th March (bp)

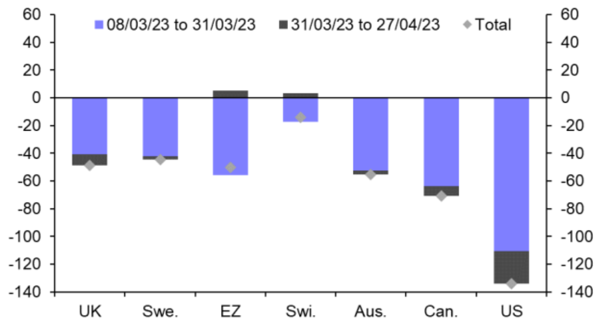


Chart 6: End-2023 CE Policy Rate Forecasts Less OIS-Implied Rates (bp)

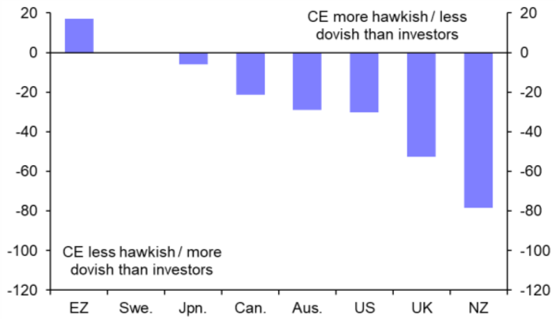
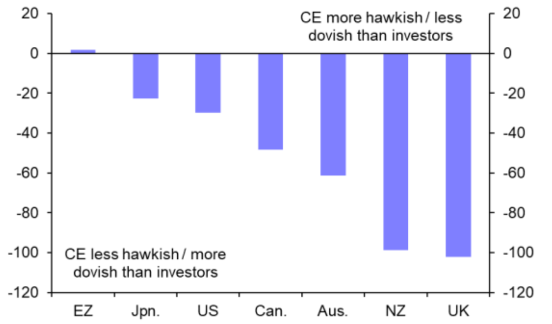


Chart 7: End-2024 CE Policy Rate Forecasts Less OIS-Implied Rates (bp)



Sources: Bloomberg, Refinitiv, Capital Economics

Government Bonds

- While most 10-year government bond yields had risen earlier in this month, they have dropped a bit over the past couple of days **(8 & 9)**. This has contributed to some mixed performance for yields since the start of this month; the Treasury yield, for example, has remained roughly flat, on net, while the Gilt yield has risen by ~25bp. Meanwhile, in euro-zone "periphery" countries, spreads to the Bund have generally widened since the start of this month, with Greece being an exception **(10)**. And with rate expectations still generally *lower* than they were prior to the banking sector turmoil, yields are still broadly *below* their early March levels**(11)**.
- In most DMs where yields have *risen* since the start of this month, that has been mostly due to higher "real" yields, which could reflect some improvement in expectations for economic growth in those places. Changes in inflation compensation, in contrast, have generally been much smaller, and in some DMs they have even *fallen* **(12)**.
- We still think DM central banks will generally keep rates a bit lower than investors anticipate in 2023 and 2024. As a result, we forecast the yields of 10-year government bonds in most DMs to fall a bit by the end of this year and in 2024 **(13)**.

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

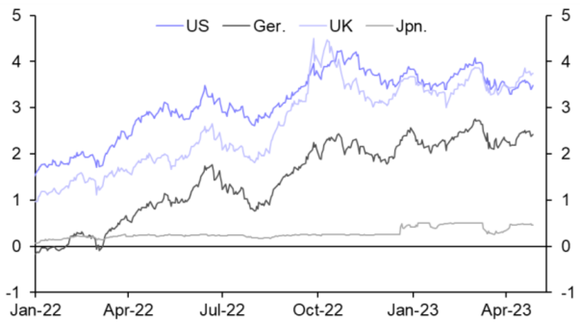


Chart 9: 10-Year Government Bond Yields (%)

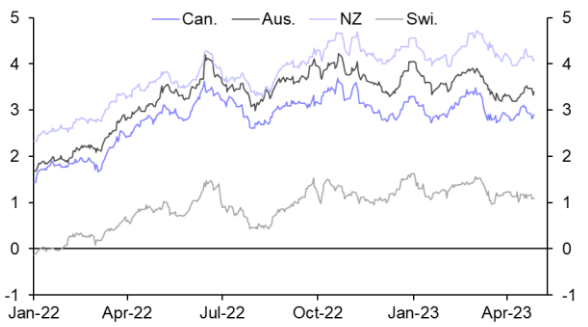


Chart 10: Estimated Decomposition Of Changes In 10-Year Government Bond Yields Since 31st March (bp)

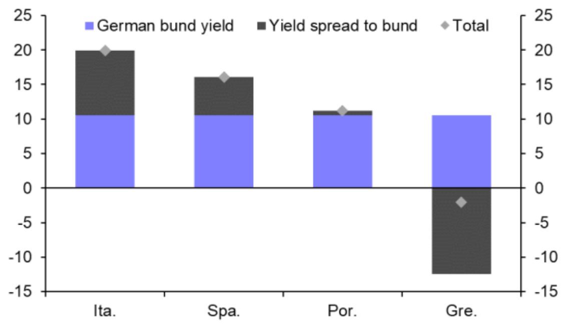


Chart 11: Changes In 10-Year Government Bond Yields Since 8th March (bp)

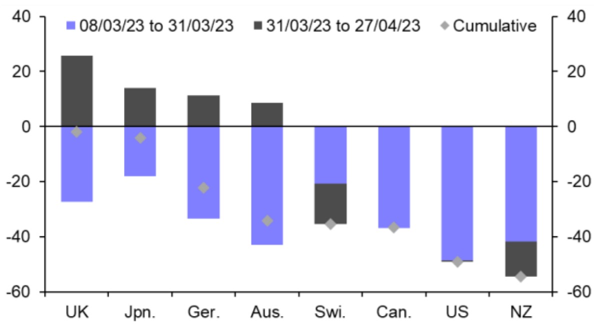


Chart 12: Estimated Decomposition Of Changes In 10-Year Government Bond Yields Since 31st March

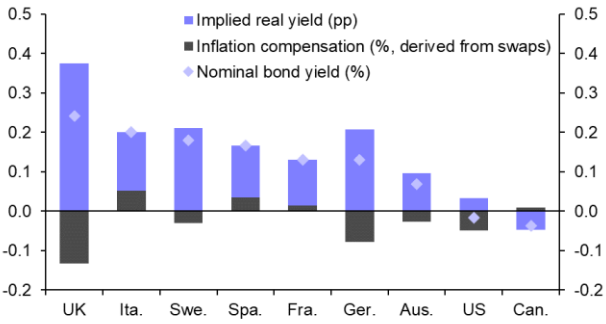
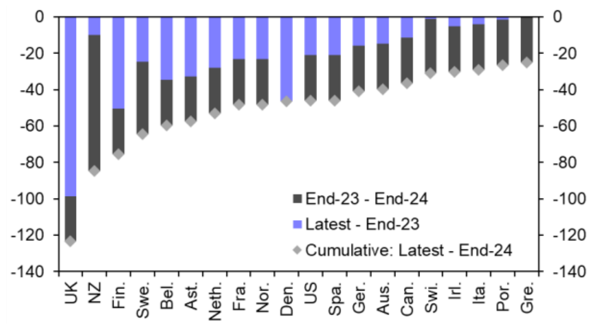


Chart 13: Changes In 10-Year Government Bond Yields Implied By CE Forecasts (bp)



Sources: Bloomberg, Refinitiv, Capital Economics

Corporate Bonds

- The changes in yields of ICE BofA ML's indices of investment-grade (IG) and high-yield (HY) corporate bonds have been mixed so far this month **(14 & 15)**. "Risk-free" rates have increased in the euro-zone and the UK, but they have fallen in the US. And while IG option-adjusted spreads (OAS) have fallen **(16)**, HY OAS have generally risen as risk sentiment has soured a bit recently and are now edging closer to their highs during the March banking turmoil **(17)**.
- IG OAS have narrowed in most sectors in the US, especially for the financial and real estate sectors. But those spreads are still materially wider than they had been before the banking turmoil **(18)**. The picture looks similar in the euro-zone **(19)** and UK, although the spreads of financials have been less affected.
- We think the recent narrowing of IG credit spreads will reverse before long if, as we expect, the US and other advanced economies fall into recession this year. And even though the worst of the banking turmoil seems to have passed, we wouldn't be surprised if one consequence of it was a further tightening in lending standards and, in turn, further upward pressure on spreads. As the economic backdrop improves next year, however, we think credit spreads will narrow across the board.

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

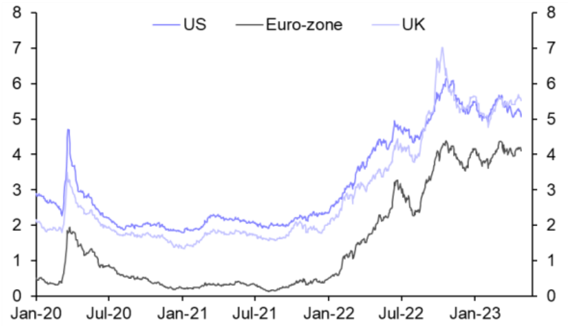


Chart 15: Yields Of ICE BofA ML HY Corporate Bond Indices (%)

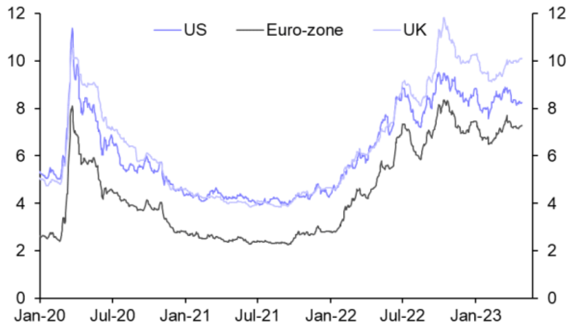


Chart 16: Decomposition Of Changes In ICE BofA ML Corporate Bond Indices Since 31st March 2023 (bp)

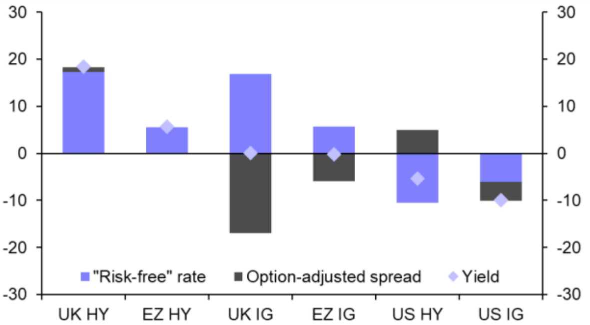


Chart 17: OAS Of ICE BofA ML IG & HY Corporate Bond Indices (bp)

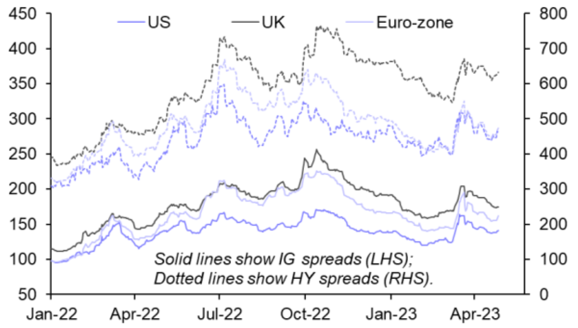


Chart 18: Changes In OAS Of ICE BofA ML US IG Corporate Bond Indices Since 8th March (bp)

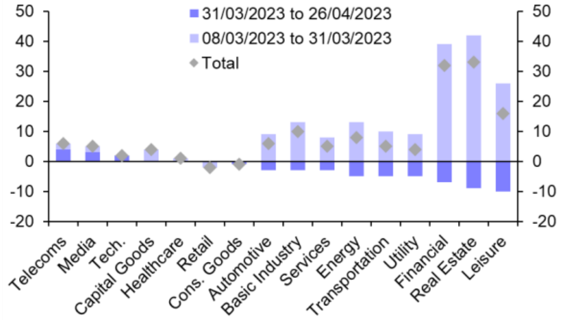
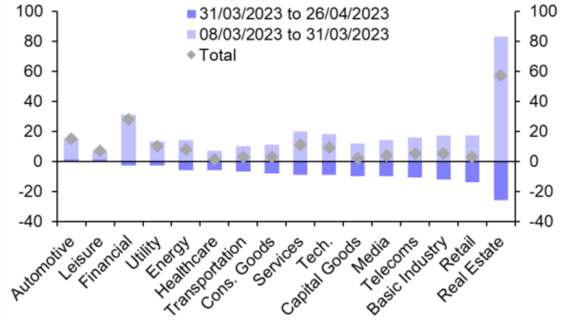


Chart 19: Changes In OAS Of ICE BofA ML EZ IG Corporate Bond Indices Since 8th March (bp)



Sources: Refinitiv, Capital Economics

Equities

- DM equities have, in aggregate, fallen a bit since 31st March, with the MSCI World Index down ~0.7% in local-currency terms over this period **(20)**. Most of the drop has been a result of losses in the US market, which has pushed the index down despite rises in most other MSCI country indices, especially in Europe **(21)**. The strength of European markets probably reflects activity data there holding up better than expected.
- At the sector level, financials have posted gains since the start of this month **(22)**, as banks have continued their post-turmoil recovery for most of April **(23)**. Meanwhile, the "tech"-heavy parts of the market – including information technology and consumer discretionary – have struggled. That may be partly because these sectors are particularly sensitive to discount rates and real safe asset yields have, on net, risen this month, at least in the US **(24)**.
- Going forward, we suspect that earnings will disappoint analysts' still-optimistic forecasts, piling further downward pressure on equities. What's more, we think risk sentiment will sour if, as we expect, the US and other advanced economies enter recessions soon. This informs our view that DM equities will generally fall further over the rest of 2023, before rebounding in 2024 **(25)**.

Chart 20: MSCI World Index (Local Currency)

Chart 21: Changes In MSCI Country Indices Since 31st March (Local Currency, %)

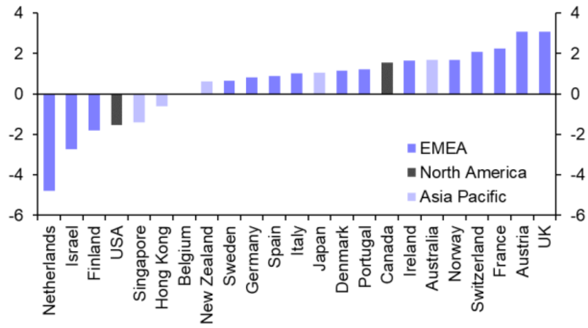


Chart 22: Changes in MSCI World Sector Indices Since 31st March (Local Currency, %)

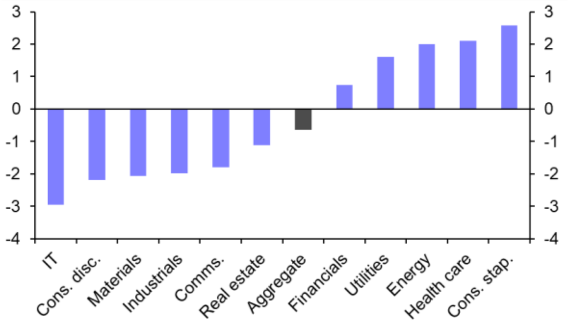


Chart 23: Bank Equity Indices (31st December 2021 = 100)

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

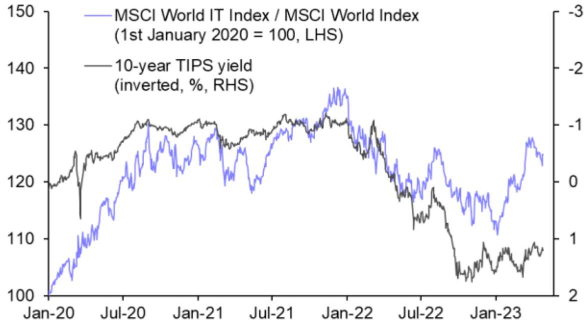
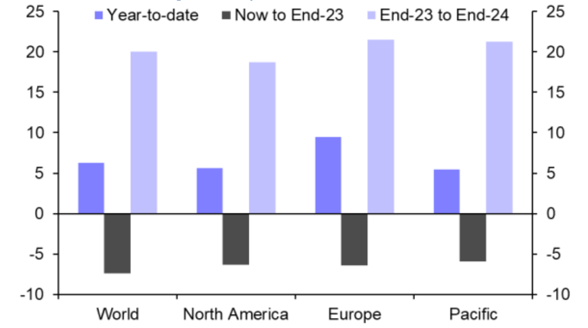


Chart 25: Changes In MSCI Local Currency Indices Implied by CE Forecasts (%)



Sources: Refinitiv, Capital Economics

Forecast Summary

Forecast Summary

	Latest (26th /27th April)	End 2023	End 2024	End 2025
Stock Market Indices (Local Currency)				
US – S&P 500	4,056	3,800	4,500	5,000
Germany – DAX 30	15,800	14,800	18,200	21,110
UK – FTSE 100	7,853	7,300	9,000	10,500
Japan – TOPIX	2,033	1,880	2,300	2,650
Canada – TSX Composite	20,367	19,000	23,500	27,420
Australia – ASX 200	7,293	7,000	8,500	9,730
10-Year Government Bond Yields (%)				
US	3.46	3.25	3.00	3.00
Germany	2.40	2.25	2.00	2.00
Italy	4.29	4.25	4.00	4.00
UK	3.72	2.75	2.50	2.50
Japan	0.46	0.75	0.50	0.50
Canada	2.87	2.75	2.50	2.50
Australia	3.40	3.25	3.00	3.00
ICE BofA ML Corporate Bond Indices – Option Adjusted Spreads (bp)				
US Investment Grade	141	190	155	130
Euro-zone Investment Grade	162	220	170	140
UK Investment Grade	174	230	185	145
US High Yield	463	540	450	400
Euro-zone High Yield	474	540	440	390
UK High Yield	632	685	590	550

Sources: Refinitiv for latest; Capital Economics for forecasts.