AllianceBernstein

Global Economic Research

Global Macro Outlook

Second Quarter 2023

The Macro Picture

As the year progresses, the 2023 outlook has become murkier rather than clearer. In addition to an ongoing inflation problem, policymakers and investors alike now grapple with financial sector turmoil. While our base case is that the turmoil won't become a full-blown crisis, it's too early to be sure. The financial sector is where small problems go to become big crises, and any investor ignoring that possibility is disregarding one of history's big lessons: when central banks raise rates, things break.

Contents

The Macro Picture 1
Global Forecast 3
US... 4
China 5
Euro Area 6
UK... 6
Japan.. 6
Emerging Markets 6
Forecast Table 8
Contributors 9

Despite that sobering prelude, we believe that this episode is unlikely to disrupt the global economy as much as past crises. For starters, the US banks under pressure are much smaller and less systemically important than the institutions that ran into trouble in the global financial crisis of 2008. Then, the most pernicious problem was a gaping hole on the asset side of bank balance sheets. Deteriorating asset quality, and investor flight from those assets, led to a rapid downward spiral in values. This galvanized more investor flight and even lower valuations on those assets, eventually threatening to render the banks insolvent. The opposite is true this time. Yes, the US bank crisis stemmed from falling asset values, but the assets in question are now US Treasuries and, rather than falling as the turmoil intensified, their value has risen. So, any gaps in bank balance sheets have shrunk, not grown, throughout the turbulence. And their smaller size has also made it easier and less costly to resolve them.

So, if the damage is manageable, what risk to the financial system required government intervention? Simple: confidence. Since in a fractional reserve system banks only need to keep a portion of total deposits on hand, deposit flight is always a risk. And it was deposit flight, not declining asset values, that required regulators to respond to the failing Silicon Valley Bank (SVB), Signature Bank and Credit Suisse. Confidence can be fickle, and it takes decisive, aggressive intervention to prevent its dissipation. Policymakers seem optimistic that their measures to guarantee deposits will prevent a systemic crisis, and we generally agree. But the situation will require close monitoring for some time before we're entirely confident that a proper crisis has been avoided.

When assessing the impact of the banking turmoil on our outlook, the underlying economic situation also matters enormously. In this case, the challenge for policymakers is that the measures needed to stem a crisis run counter to those suggested by the state of the global economy. Whereas banking sector stress can be alleviated by more liquidity and lower interest rates, stronger growth and stickier inflation require less liquidity and higher interest rates. And the data received during the first quarter of the year paint a picture of a global economy that's growing more strongly and suffering from stickier inflation than previously thought.

That means that if the financial sector turmoil spirals into a full-blown crisis, it may prove challenging for authorities to tailor appropriate responses without risking persistently higher prices. We expect that monetary, rather than fiscal, policymakers will have to do most of the heavy lifting if the situation deteriorates. They'll also focus on distinguishing between the temporary provision of liquidity to support banks and the more durable interest-rate tools that target the macroeconomy. Striking that balance may prove difficult, however, and risks remain. That said, the macro starting point is a strong one, which should allow the global economy to avoid anything worse than a mild recession, should the banking sector continue to function normally.

In the US, growth in the first quarter (1Q) has been well above trend, supported by a robust labor market and healthy consumer financials. The flip side of that strength is that strong demand has kept inflation elevated despite aggressive Fed rate hikes over the

last year. Services inflation in particular shows few signs of slowing as yet, and we expect that it will take a prolonged period of below-trend growth to bring price pressures under control. In that respect, the impact of the banking turmoil may prove helpful: we expect small banks especially to be more cautious in extending credit than they otherwise would have been, which will contribute to slower economic growth. We expect growth near 0% for the rest of 2023 alongside a gradual weakening of labor markets that will combine to bring inflation closer to target this year and pave the way for full convergence in 2024.

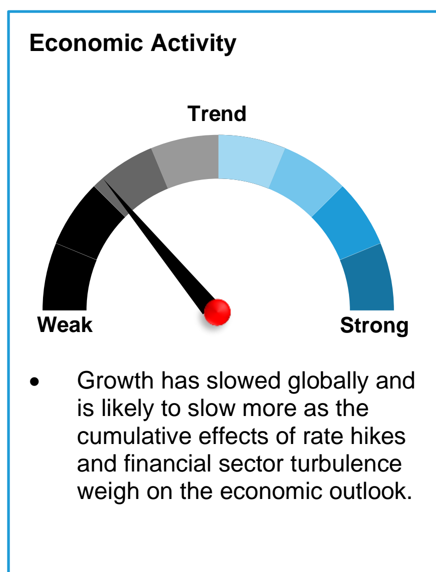
In Europe, a mild winter and sharp decline in natural gas prices have mitigated much of the downside economic risk we identified last year. Durably lower fuel prices have helped households maintain spending levels even as higher interest rates have begun to have an impact. The European Central Bank (ECB) is a few months behind the Fed this cycle, and likely to continue raising rates for the time being. We don't expect the forced merger of UBS and Credit Suisse to have a meaningful impact on the economic outlook. As in the US, a sustained period of weak growth will be necessary to achieve inflation convergence, and we anticipate that the ECB will continue raising rates until that outcome appears likely. As a result, we forecast slower growth later in 2023 and into 2024.

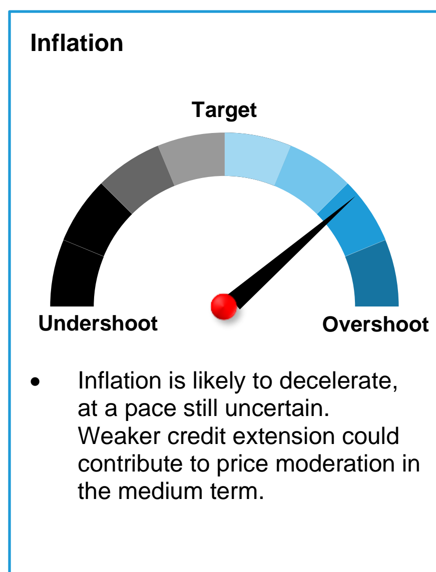
Asia is off cycle with the rest of the global economy. In Japan, more than two decades of extremely accommodative monetary policy, culminating in the current yield-curve control regime, may finally be bearing fruit. Recent information on wage settlements suggests that inflation and inflation expectations may finally be resetting higher. Ironically, just as Japan's policy seems as if it might be working, the Bank of Japan (BOJ) may be changing course. The changing of the guard at the BOJ may pave the way for tighter monetary policy later this year, a step that we believe would be premature.

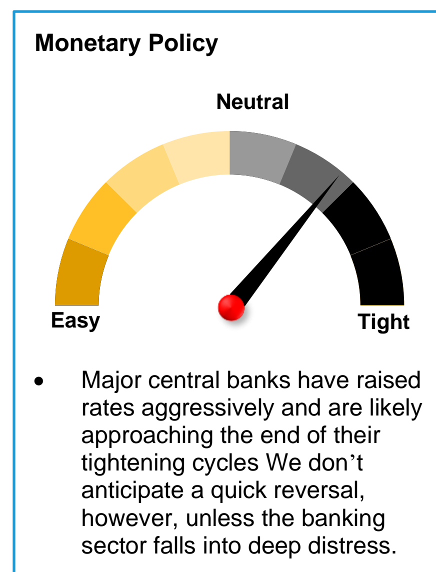
China has fully reopened its economy from pandemic-led shutdowns, and we expect no further disruptions. Because its reopening was so much slower than most other countries, China's economy is just now beginning to accelerate, a process we anticipate will continue for most of this year. The People's Bank of China recently cut bank reserve requirements to free up more liquidity, a move we think signals their seriousness in supporting growth. We expect growth will be more inward facing than past expansions and thus less likely to pull other economies along for the ride. But we think the acceleration will nonetheless be an important source of support for the global economy in these challenging times.

What does this mean for financial markets? Our expectation of a sustained period of below-trend growth, driven by some combination of tight monetary policy and banking sector distress, argues for caution. But unless the banking turmoil spirals out of control, we expect only a mild recession in most regions and a considerably brighter outlook toward year-end. For investors, this argues for caution, not panic.

The Global Cycle for Q2:2023







Global Forecast

Forecast Overview

Key Assumptions

- **Financial:** We do not expect the ongoing banking sector turmoil to spiral into a systemic crisis.
- **Geopolitical:** We expect that tensions between major powers will continue to simmer but will not boil over into economically disruptive events.
- **Monetary policy:** Major central banks are at or near the end of their tightening cycles, but still-elevated inflation makes a quick reversal unlikely.

Central Narrative

- **Global growth:** Tight monetary policy and banking sector stress will combine to slow growth appreciably outside of China.
- **Inflation:** Inflation is likely to be sticky for a few more months but should slow significantly thereafter.
- **Yields:** Risks around yields are more balanced as banking sector stress injects plausible downside to yields, even amid high inflation.
- **USD:** As the peak in interest rates approaches, the dollar may give back some of its 2022 gains.

Key Upside Risks

- A near-term resolution to banking stress could boost sentiment.
- A lower path for policy interest rates would support growth.

Key Downside Risks

- Banking sector turmoil could spiral into a crisis.
- The debt ceiling in the US remains a key risk in the coming months.

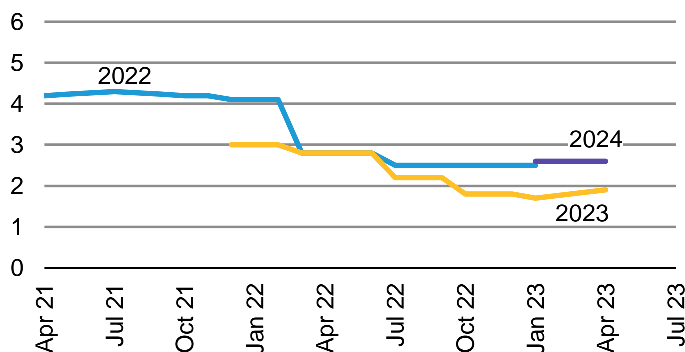
AB Growth and Inflation Forecasts (Percent)

	Real GDP Growth		CPI Inflation	
	2023	2024	2023	2024
US	–0.1	1.8*	3.5	2.0
Euro Area	0.3	0.8	5.2	2.0
Japan	1.5	1.0	2.0	1.5
China	5.1	5.0	2.3	2.3
Global	1.7	2.4	5.1	3.3
Industrial Countries	0.3	1.4	4.0	2.0
Emerging Countries	3.7	3.9	6.6	5.0
EM ex China/Russia	2.5	3.1	11.9	8.0

*US GDP forecasts presented as Q4/Q4; others YoY. As of March 29, 2023
Source: AB

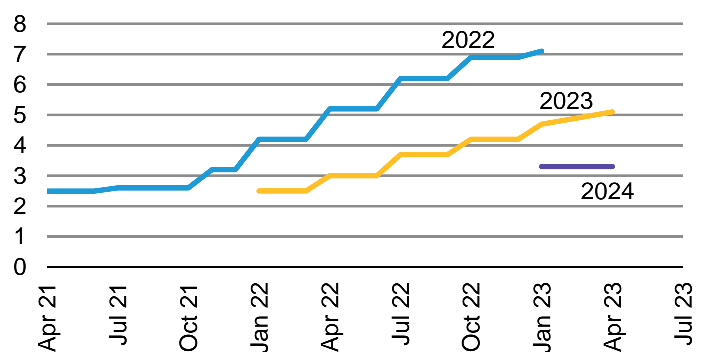
Forecasts Through Time

AB Global Growth Forecasts by Vintage



As of March 30, 2023
Source: Bloomberg, Morgan Stanley Research and AB

AB Global Inflation Forecasts by Vintage



As of March 30, 2023
Source: Haver Analytics and AB

US

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)	
	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F
US	–0.1	1.8	3.5	2.0	4.625	3.125	3.5	2.5

- The US economy significantly outperformed our expectations in 1Q. With the exception of the manufacturing sector, which is suffering from the double whammy of dollar strength and the post-pandemic consumer rotation to services, the economy appears to have accelerated despite the past year's significant Fed rate hikes.
- The strong growth performance both reflects and underpins the labor market, which remains extremely tight. Unemployment is at a multi-decade low, with hiring rates well above estimates of newly joining workers.
- Inflation, too, continues to confound most expectations, which were for prices to slow more rapidly. While we weren't as convinced as the market that rapid disinflation would proceed, even our expectations fell short of the outturn in 1Q.
- Taken together, the trifecta of strong growth, a tight labor market and higher-for-longer inflation would argue for a continuation of the Fed's tightening campaign, all else being equal.
- But all else is not equal. Prior rate increases contributed to significant stress in the banking sector, especially regional banks. While it's too early for a strongly held view about the impact of that stress, it's very likely that banks will become more conservative in light of it. That will result in diminished credit flows and help to slow the economy. In the benign scenario, the bank stress will pass but the tightening of credit conditions will remain, helping to do some of the Fed's work for it and reducing the need for additional tightening.

Risk Factors

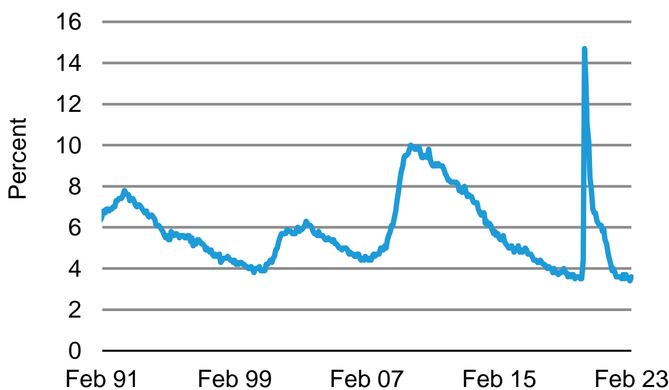
- We have flagged in past quarters the risk of financial sector instability during a tightening cycle. Now that it's here the question is how severe it will become. A benign outcome may result in little more than an economic hiccup, but an escalating crisis could cause a much more negative outcome.
- Political risk is ever-present, but with the debt ceiling debate ahead of us, the risk to US sovereign creditworthiness as a result of political sclerosis will increase in the months ahead.

Overview

The outlook seemed clear for most of the first quarter: stronger-than-expected growth and inflation would result in an extended tightening cycle. Late in the quarter, however, financial sector instability injected unwelcome uncertainty into the picture. Few would have expected regional banks to be ground zero for this episode. But, often in tightening cycles, stress turns up in unexpected places. The good news is that this bout of stress seems to be manageable from a system-wide perspective. The banks in question are relatively small compared with the system as a whole and the underlying asset that caused the issues is Treasury debt, for which there is a very deep and liquid market. That means that the losses are transparent and the hole in bank balance sheets not too hard to fill. The trouble is that confidence can be fickle, and the extent to which depositors flee smaller institutions remains to be seen. Our base case is that the stress will pass without a true crisis, but it's still early.

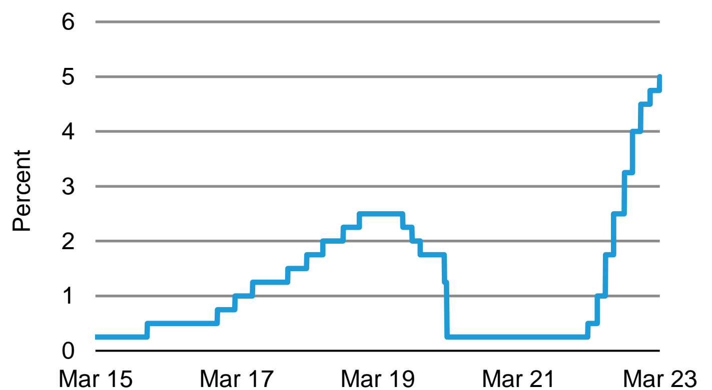
If we are correct that the stress does not overly escalate, it may help to do some of the work of rebalancing the economy for the Fed. Slower credit extension would lead to slower growth and, eventually, weaker labor markets and lower inflation. That, of course, is the outcome the Fed has been working toward all along. As a result, we view the stress as likely to accelerate the process rather than force a change in direction. In the end, we continue to expect a mild US recession, though downside risks have clearly increased in recent weeks.

Unemployment Rate



As of March 30, 2023
Source: Refinitiv Datastream

Fed Funds Target Rate



As of March 30, 2023
Source: Refinitiv Datastream

China

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F
China	5.1	5.0	2.3	2.3	2.0	2.0	3.1	3.0	6.7	6.5

Outlook

- After nearly three years, China's economy has fully reopened from the pandemic. Alternative data measures show commuter traffic and other activity gauges returning to normal. As was the case elsewhere, we think a reopened China will enjoy a period of above-trend growth as society returns to normal.
- While the experience of other countries suggests that inflation will eventually rise as reopening proceeds, China is not yet at that stage of its cycle. That means policymakers have been able to take steps to support growth including, most recently, a cut in the reserve requirement ratio (RRR) that should free up significant liquidity.
- We expect policymakers in China to emphasize domestic drivers of demand in their efforts to boost growth rather than focusing on the external sector. That will limit the impact of a Chinese expansion on other economies.

Risk Factors

- One potential consequence of policy supporting growth in China could be a reacceleration of the housing sector, where there are already significant imbalances. Adding more demand could increase future instability.
- While domestic politics seem unlikely to be disruptive, China's efforts to play a larger role in world events is raising tensions with other countries. To the extent that tensions spill into economic policy, it will be a headwind to future growth.

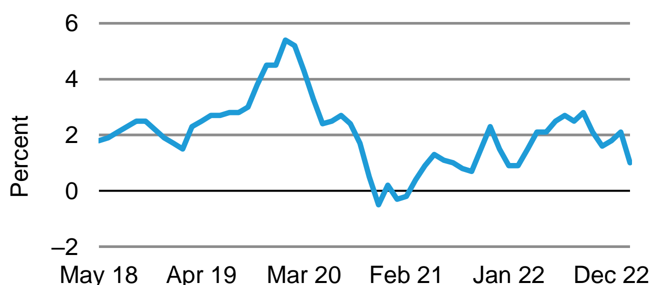
Overview

China is late to the reopening game, which has left its economy at a very different place than that of other major economies. While others battle inflation by raising rates in the wake of surging growth, China's inflation remains quite low and its central bank is boosting growth, not slowing it. We anticipate that China will enjoy a reopening-related growth boost similar to that of other economies. As a result, it stands out from other major markets in that we expect growth to be much higher this year versus 2022. Eventually, we expect price pressures to increase in China and policy to become more cautious, but not just yet.

Instead, the potential cracks in China's economy come from existing imbalances and the possibility that efforts to boost growth could exacerbate them. The property sector stands out on two levels: having already suffered periods of being overextended and as the sector most responsive to policy initiatives. Renewed housing demand and/or increasing property prices might boost growth in the near term but at the cost of creating problems down the road. We expect policymakers will try to avoid boosting housing too much, but it's hard to support the economy without pushing at least some stimulus through this important sector.

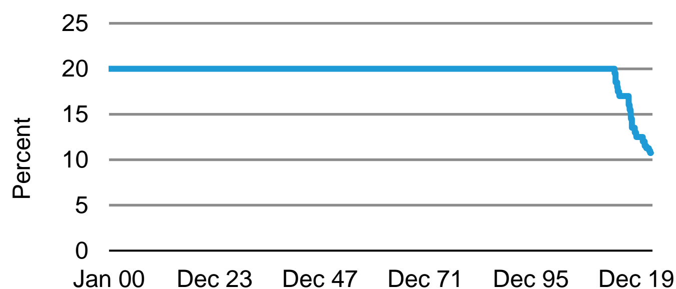
The other point of friction for China comes from overseas. Increasing domestic demand to create a more balanced economy has long been a policy priority and we expect that goal to become even more important. The geopolitical environment is becoming less favorable for China, particularly as tensions with the US increase. This means that the Chinese economy will need to become less sensitive to the global economy. That sort of transition is difficult, but it's necessary for the long-term health of China's economy.

China CPI



Through March 30, 2023
Source: Bloomberg

China RRR



Through March 30, 2023
Source: Bloomberg

Euro Area

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F
Euro Area	0.5	0.7	5.0	2.0	3.25	2.0	2.50	**1.75**	1.15	1.15

Overview

The outlook for the European economy has brightened materially in recent months. A mild winter, proactive stockpiling of natural gas and falling global energy prices have curtailed significant downside risks to the economic outlook, and a recession now appears far less likely than it did just a few months ago.

The improved outlook has come at the cost of a deteriorating inflation picture: price pressures are intense and haven't abated. That has forced the ECB into aggressive tightening. As in the US, the central bank will have to assess the impact of financial sector turbulence before moving forward. But based on what we know today, there's likely to be more tightening to come.

UK

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F
UK	–0.5	1.0	6.0	1.8	4.0	2.5	3.0	2.5	1.30	1.30

Overview

The UK economy, like Europe, has benefited from the moderation of global energy prices. That, combined with fiscal measures to limit the impact of past increases on households, has improved the outlook materially. One wouldn't characterize the outlook as bright, necessarily, only somewhat less dark than a few months ago.

One reason the improvement in the outlook is somewhat limited is that better growth has brought with it more durable inflation. That has led the Bank of England to continue raising rates, albeit more cautiously and more hesitantly than the ECB.

Japan

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F
Japan	1.5	1.0	2.0	1.5	0.25	0.25	0.75	0.75	120	120

Overview

Japan is at a potential inflection point. Recent wage increase data suggest that the Bank of Japan's (BOJ) extremely accommodative monetary policy is boosting pay settlements, which is a critical precondition for moving inflation durably higher. Those data come, however, just as BOJ transitions to new leadership, which is reportedly skeptical about the continuing efficacy of the current policy regime. We expect new BOJ leaders will move to end or significantly modify yield-curve control later this year. In our view, that pivot would be premature—it would be better to let positive inflation become more deeply ingrained first, rather than risk sliding back into deflation in the medium term.

Emerging Markets

	Real GDP (%)		Inflation (%)		Policy Rate (%)		10-Yr. Bond Yield (%)		FX Rates vs. USD	
	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F
EM ex China/Russia	2.5	3.1	11.9	8.0	11.17	8.35	6.93	6.41	—	—
Asia	4.1	4.2	4.4	3.5	4.75	4.0	5.05	4.74	—	—
LATAM	0.3	1.4	20.5	13.8	24.68	16.72	9.23	7.41	—	—
EEMEA	0.3	1.3	15.1	10.2	8.78	8.72	5.46	5.99	—	—

Outlook

- The unexpected resilience in developed market (DM) labor markets and sticky inflation in DM and emerging markets (EM) put central banks back on high alert.

- The financial sector turmoil might blow over, but risks of adverse and real economic spillovers (credit crunch) have increased.
- This ostensibly means more financing needs and less financing sources for EM.

Risk Factors

- Risks related to EM debt sustainability are driven by the buildup of debt burdens over several years, and an unfriendly trend in interest-rate and growth differentials.
- Idiosyncratic risks clearly become more binding in a stagflationary environment.

Overview

EM asset prices started 2023 strongly with support from China's reopening, easing global financial conditions and the prospect that interest-rate-hiking cycles are close to concluding. The unexpected resilience in DM labor markets, and signals of sticky inflation across DM and EM, however, put central banks back on high alert. As core yields moved back up and US-dollar weakness started to reverse, the window to issue external debt closed for those EMs that generally need it the most. And then came the financial sector turmoil—with the risk of adverse and real economic spillovers (i.e., a credit crunch). This ostensibly means more financing needs and fewer financing sources for EM.

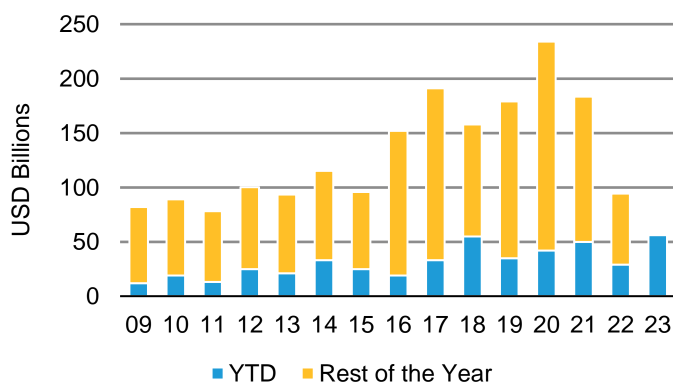
EM issuance was robust at the start of 2023, but it was generally the higher quality sovereigns that managed to tap bond markets (Figure 1). The uncertain macroeconomic backdrop could lead to another year of relatively low EM sovereign issuance, which would tighten the noose for lower-rated EMs. Liquidity issues might turn into solvency challenges for some if market access continues to be pushed out. Risks related to solvency/debt sustainability are, of course, essentially being driven by the buildup of debt burdens over several years, and an unfriendly trend in interest-rate and growth differentials.

EM central banks have generally led DM policymakers in the interest-rate-hiking cycle. That bolstered EM central bank credibility and shielded EM asset prices to some extent. But by starting earlier, the effects on employment also kicked in earlier. By the end of 2022, employment growth in DM was still strong while it halted in EM. DM employment generally remained strong early in 2023, and while EM employment data for the year-to-date are sparse, further softening seems likely. The stagflationary backdrop (and potential rise in unemployment) raises the risk of social discontent. Figure 2 shows the intersection of stagflationary risks, social risks versus the institutional capacity to offset some of those risks, and some of the countries with political events that might trigger a vicious cycle.

In Turkey, for example, there is potential for political reform due to the pressure from stagflationary conditions and social distress exacerbated by the tragic recent earthquake. But institutional guardrails are relatively weak and political risks are, therefore, significant. Another country under pressure from multiple angles is Pakistan. The country is going through one of the worst economic crises in decades, partly owing to floods and macroeconomic mismanagement. The parliamentary elections amid an increasingly acrimonious political environment present significant challenges from a macroeconomic and asset-price perspective. Egypt also looks vulnerable, in our view. Meaningful devaluation of the currency did not restore external balance, and while the government's ambitious divestment plan should provide some liquidity relief, it's unlikely to move fast or far enough to reverse macro and financing dislocations. Idiosyncratic risks clearly become more binding in a stagflationary environment.

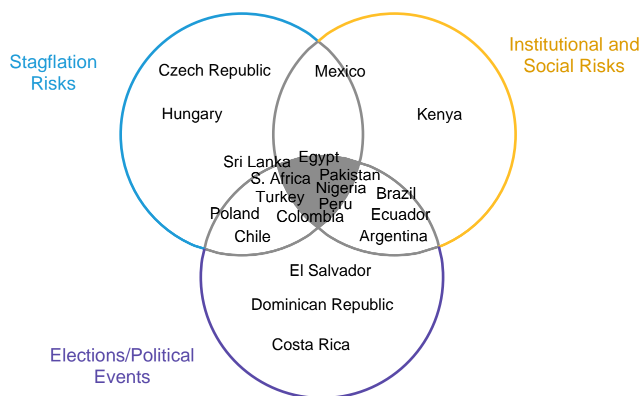
The global backdrop has become more uncertain—and more challenging—for EM. The turmoil in the financial sector might blow over, but the relatively unfriendly trend in the interest-rate/growth differential could be a longer-lasting fundamental headwind for EM.

EM Sovereign Gross Issuance



As of March 2, 2023
Source: Bloomberg, Morgan Stanley Research and AB

The Intersection of Stagflation, Institutional/Social Risks and Political Events



Source: Haver Analytics and AB

Forecast Table

	Real Growth (%)		Inflation (%)		Official Rates (%)		Long Rates (%)		FX Rates vs. USD	
	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F	2023F	2024F
Global	1.9	2.5	5.1	3.3	4.80	3.64	3.59	3.08	—	—
Global Ex Russia	2.0	2.5	5.1	3.2	4.74	3.46	3.67	3.11	—	—
Industrial Countries	0.7	1.5	4.0	2.0	3.71	2.50	2.90	2.15	—	—
Emerging Countries	3.7	3.9	6.6	5.0	6.35	5.20	4.58	4.37	—	—
EM ex China	2.2	2.8	11.1	7.8	10.78	8.46	6.16	5.73	—	—
EM ex China/Russia	2.5	3.1	11.9	8.0	11.17	8.35	6.93	6.41	—	—
US	-0.1	1.8	3.5	2.0	4.63	3.13	3.50	2.50	—	—
Canada	0.7	1.5	3.5	2.2	4.25	2.75	3.00	2.50	1.35	1.30
Europe	0.3	0.8	5.2	2.0	3.39	2.09	2.59	1.89	1.18	1.18
Euro Area	0.5	0.7	5.0	2.0	3.25	2.00	2.50	1.75	1.15	1.15
UK	–0.5	1.0	6.0	1.8	4.00	2.50	3.00	2.50	1.30	1.30
Japan	1.5	1.0	2.0	1.5	0.25	0.25	0.75	0.75	120	120
Australia	2.0	1.8	5.0	2.5	3.60	3.00	3.75	2.75	0.75	0.75
New Zealand	1.8	1.5	5.0	2.3	4.50	3.50	3.75	3.00	0.68	0.68
China	5.1	5.0	2.3	2.3	2.00	2.00	3.10	3.10	6.70	6.50
Asia Ex Japan & China	4.1	4.2	4.4	3.5	4.75	4.00	5.05	4.74	—	—
Hong Kong	3.5	3.5	2.4	2.2	5.25	2.75	3.00	2.50	7.85	7.85
India	6.0	5.5	6.1	5.2	6.75	6.00	7.00	6.80	82.0	80.0
Indonesia	4.5	4.3	4.3	3.5	5.75	4.75	6.60	6.50	15,000	14,500
Korea	1.5	2.5	3.3	2.0	3.50	2.50	3.75	2.75	1,220	1,165
Thailand	3.7	3.8	2.9	2.1	2.00	1.75	2.50	2.35	33.0	32.8
Latin America	0.3	1.4	20.5	13.8	24.68	16.72	9.23	7.41	—	—
Argentina	–4.0	0.5	130.0	80.0	130.00	90.00	—	—	500.0	800.0
Brazil	0.6	1.0	5.5	5.0	12.00	6.00	11.00	8.00	5.00	5.00
Chile	–0.5	2.0	8.0	4.0	8.00	5.00	5.00	5.25	900	900
Colombia	1.2	1.9	8.5	4.5	11.00	7.50	10.50	8.00	4,800	4,500
Mexico	1.2	1.8	5.2	4.1	10.00	8.00	8.00	8.25	19.8	20.0
EMEA	0.3	1.3	15.1	10.2	8.78	8.72	5.46	5.99	—	—
Hungary	0.5	2.5	12.0	5.0	10.00	4.00	6.75	6.00	380	400
Poland	0.5	2.5	11.9	5.7	6.50	3.00	6.00	5.00	4.60	4.75
Russia	0.0	0.5	5.0	4.7	7.50	7.50	—	—	85.0	85.0
South Africa	0.3	1.0	5.8	4.7	7.25	6.00	10.00	9.50	17.8	17.5
Turkey	1.0	2.0	47.3	33.0	15.00	20.00	15.00	20.00	22.00	24.00

Growth and inflation forecasts are calendar year averages except US GDP, which is forecasted as Q4/Q4. Interest rate and FX rates are year-end forecasts.

Long rates are 10-year yields unless otherwise indicated.

The long rates aggregate excludes Argentina and Russia; Argentina is not forecasted due to distortions in the local financial market; Russia is not forecasted because local market is inaccessible to foreign investors.

Real growth aggregates represent 29 country forecasts not all of which are shown.

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Investment Risks to Consider

The value of an investment can go down as well as up and investors may not get back the full amount they invested. Past performance does not guarantee future results.

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LF-366235-2023-03-31
ICN2023552