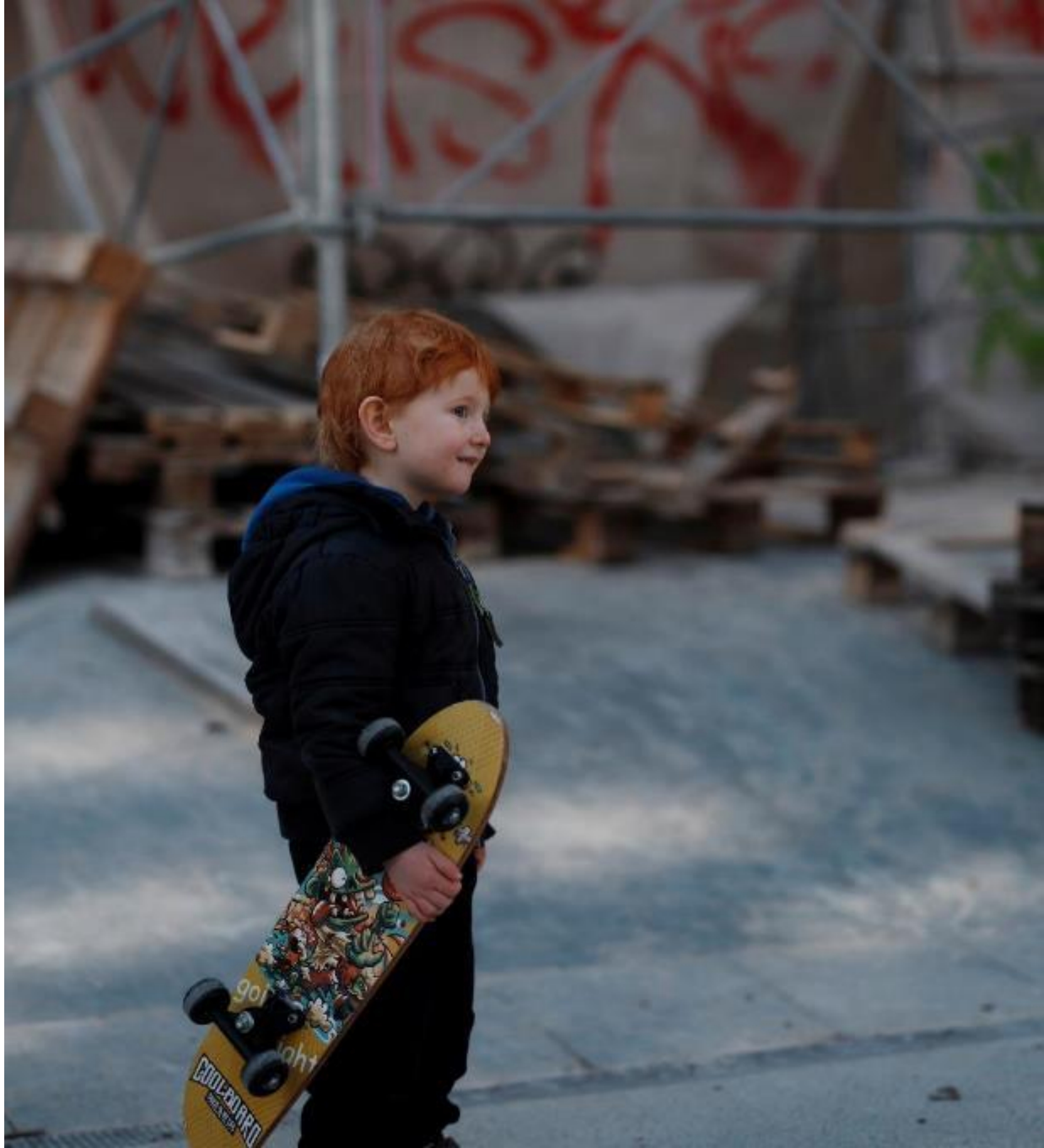
Economic Outlook
Don't Look Up!



AZR Scenario_Q12022
Allianz Research | Ludovic Subran January 13, 2022

Executive Summary (1)

The recovery of global growth is still robust but has become increasingly uneven, with rising divergence between advanced and emerging market economies.

- Our GDP forecast remains broadly unchanged, with Eurozone and the US growing at 4.1% and 3.9%, respectively. Advanced economies will continue to drive the recovery while emerging markets are not in the driving seat anymore, for the first time since the GFC.
- Growth in China is expected to slow to 5.2% due to ongoing disruptions in the real estate sector and government focus on financial stability.
- China's lowest contribution to global growth since 2015 is likely to have negative spillover effects on emerging markets whose recovery might be shallower compared to past crises.

Pervasive supply-demand imbalances are pushing up inflation until the end of the first half of 2022 as originally expected.

- Inflation is likely to decelerate this year as the recovery becomes entrenched, mainly reflecting the phase-out of transitory factors and declining energy prices.
- Central banks are shifting towards a more hawkish monetary stance to prevent inflation from becoming embedded in expectations and mitigate FX risks.

- The fiscal consolidation in Europe will be stronger than in the US, where the fiscal impulse remains stronger next year.
- Most emerging market countries are reducing budget deficits and re-build fiscal space, but commodity exporters remain vulnerable to slowing external demand from China.

Executive Summary (2)

Global trade is expanding once again above long-term average.

- We expect global trade in volume to grow by +5.4% in 2022 and +4.0% in 2023. In the short run, new Covid outbreaks will continue to keep disruptions and cost pressures high. During the next 2-4 months, we expect production shortfalls to increase in China and keep supply chain-driven inflation higher for longer, at 1.5-2.5pp in the Eurozone and US, around half of the total core inflation.
- We anticipate normalization of trade as transportation bottlenecks reach a turning point during H2 2022. Three factors will help the normalization: (i) a cooling of consumer spending on durable goods; (ii) less input shortages as inventories return to (or even exceed) pre-crisis levels; and (iii) declining delivery times as higher capacity eases shipping constraints.

Gradually rising rates have supported a benign capital market environment.

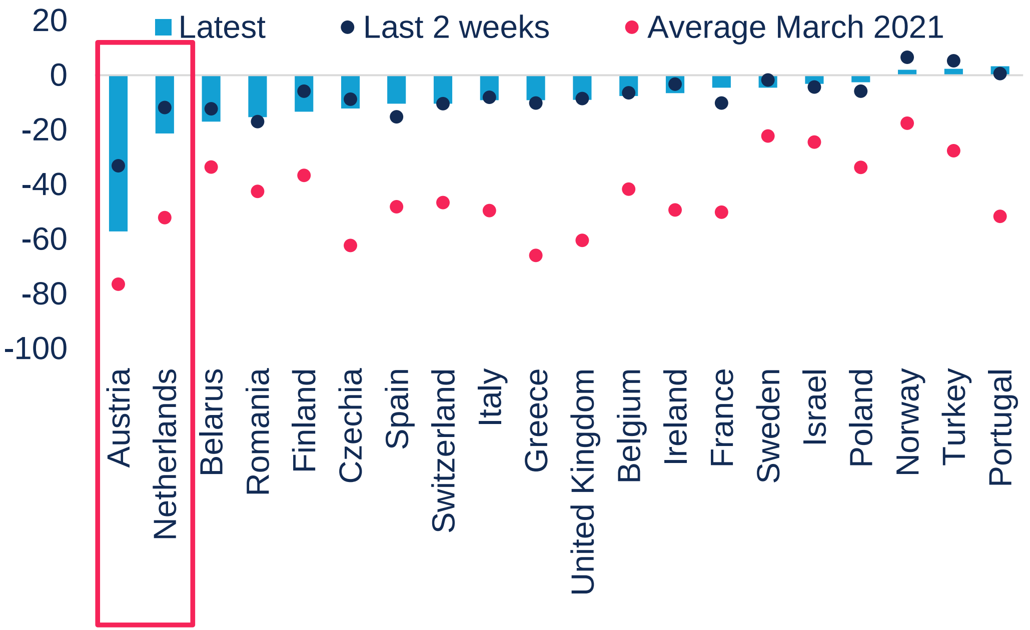
- Unchanged, or even declining risk premia, and declining real interest rates have supported favorable financing conditions and the performance of risky assets.
- Risk sentiment underpinning historically high valuations remains dependent on the gradual removal of policy support.

Risks to the outlook are generally tiled to the downside.

- The emergence of the omicron virus mutation has created renewed uncertainty while the economic impact of the virus is generally weakening.
- Tighter financial conditions or a premature withdrawal of policy support could undermine the recovery and increase private and public sector vulnerabilities, with the potential for cliff-edge effects in some countries.
- Greater divergence of fiscal and monetary policy normalization across countries could further increase imbalances across countries and disrupt the recovery of international trade.

Covid-19: Becoming endemic?

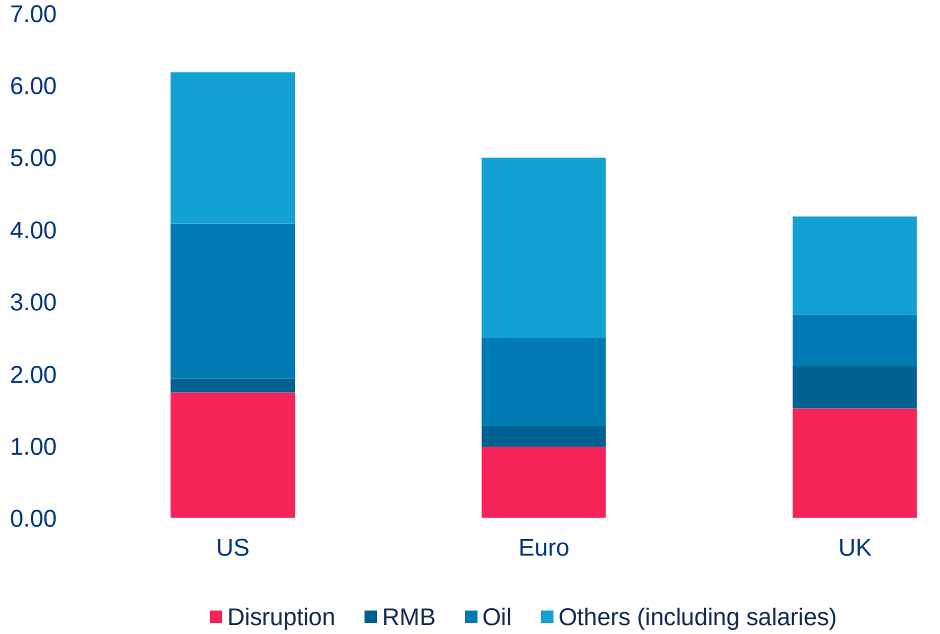
Retail & recreation mobility
(% deviation from baseline)



Sources: Datastream, Euler Hermes, Allianz Research

Negative confidence effects start to be visible but falls remain very moderate for now.

Supply-side disruptions' contribution to inflation
(October or November 2021, pp)



Sources: Datastream, Euler Hermes, Allianz Research

Continued supply chain bottlenecks affecting trade with China could keep inflationary pressures elevated.

Growth: Strong, but still uneven

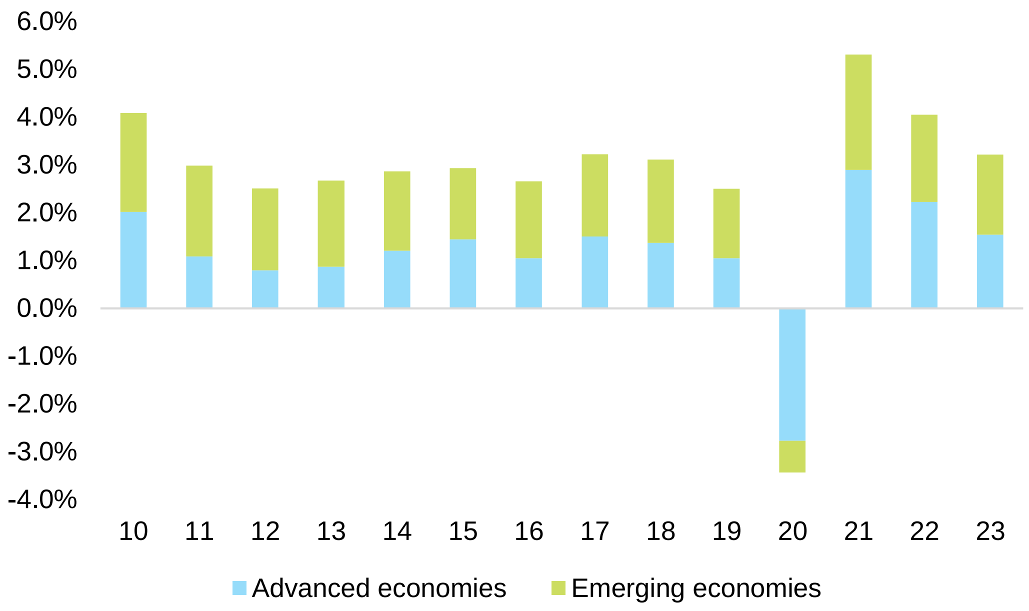
Global Growth Forecast (yearly%)

	2019	2020	2021	2022	2023
World GDP growth	**2.5**	**-3.4**	**5.4**	**4.1**	**3.2**
United States	2.3	-3.5	5.6	3.9	2.8
Latin America	**0.2**	**-6.9**	**6.3**	**3.0**	**2.1**
Brazil	1.4	-4.1	4.8	1.5	1.2
United Kingdom	1.4	-9.9	7.1	4.4	2.6
Eurozone members	**1.5**	**-6.5**	**5.2**	**4.1**	**2.3**
Germany	1.1	-4.9	2.7	3.7	2.3
France	1.8	-8.0	6.7	3.6	1.9
Italy	0.3	-8.9	6.3	4.5	2.1
Spain	2.1	-10.8	5.0	5.7	3.2
Russia	2.0	-3.0	4.0	3.0	2.5
Turkey	0.9	1.8	10.7	1.5	4.2
Asia-Pacific	**4.0**	**-1.0**	**5.8**	**4.7**	**4.4**
China	6.0	2.3	7.9	5.2	5.0
Japan	0.0	-4.7	1.9	2.5	1.6
India	4.1	-7.3	8.5	7.1	6.9
Middle East	**0.4**	**-4.1**	**3.1**	**3.7**	**2.5**
Saudi Arabia	0.3	-4.1	3.0	4.7	2.4
Africa	**1.7**	**-2.6**	**2.9**	**3.5**	**3.8**
South Africa	0.3	-6.4	4.4	2.0	1.4

NB: fiscal year for India

Advanced economies will continue to drive more than half of the global GDP growth (+2.2pp to 4% in 2022, +1.6pp to 3.2% in 2023).

Contribution to GDP growth

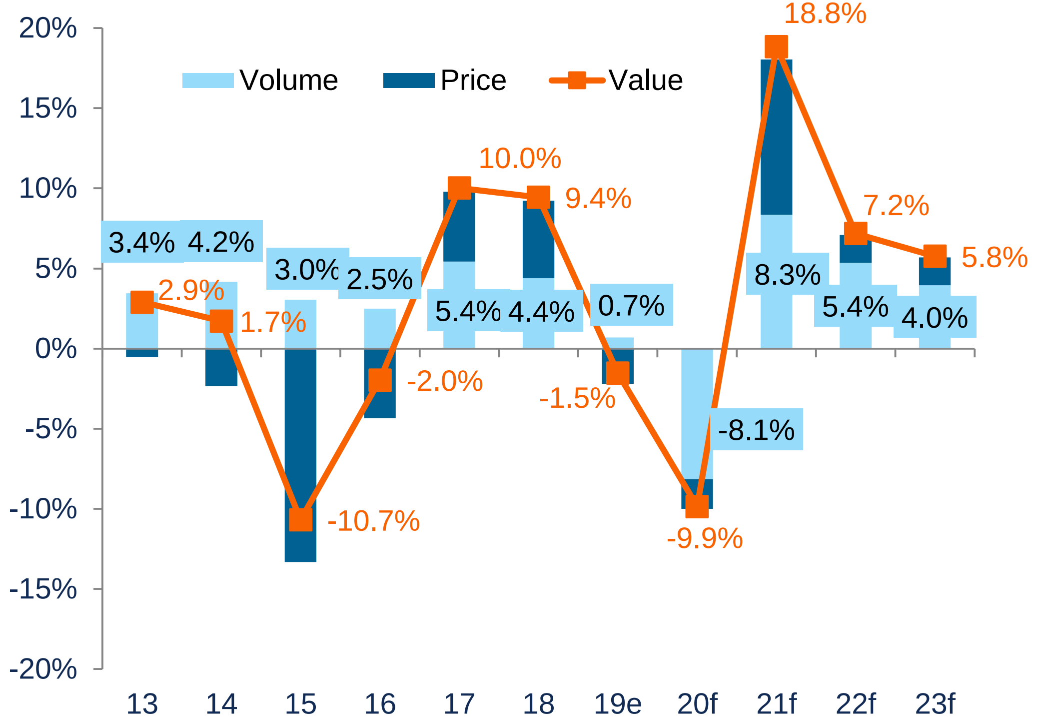


Sources: OECD, Euler Hermes, Allianz Research. Data goes until end of November.

China's slowdown will weigh on the pace of the recovery and marks its lowest contribution to global growth since 2015.

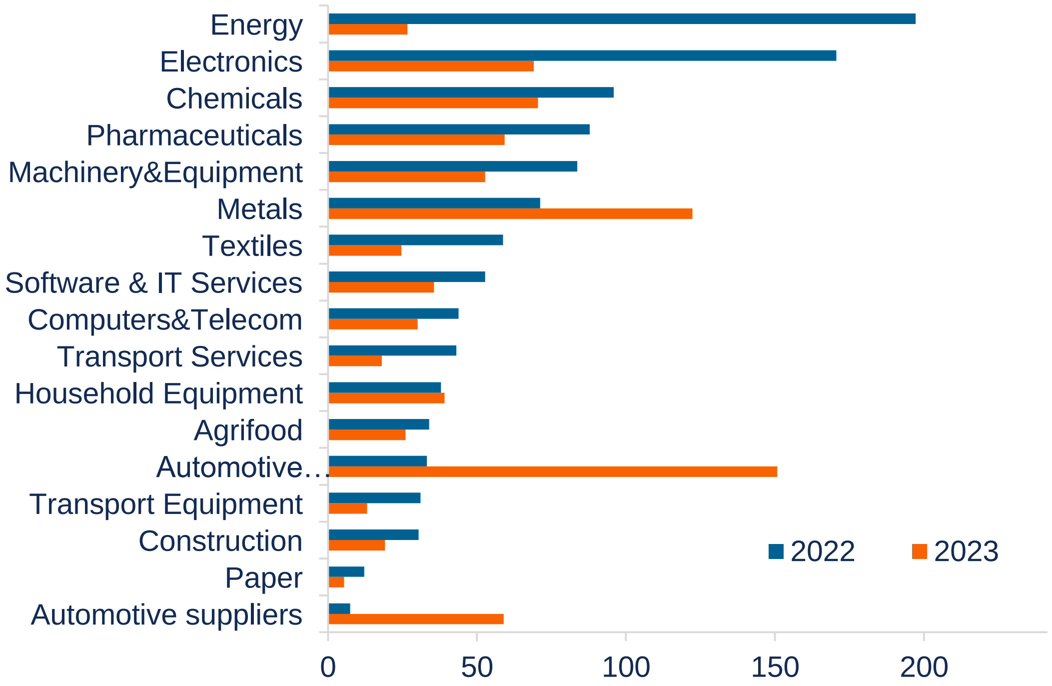
Trade: Above long-term average in '22/23

Global trade growth



Sources: CPB, Euler Hermes

Trade by sector, yearly change (USDbn)



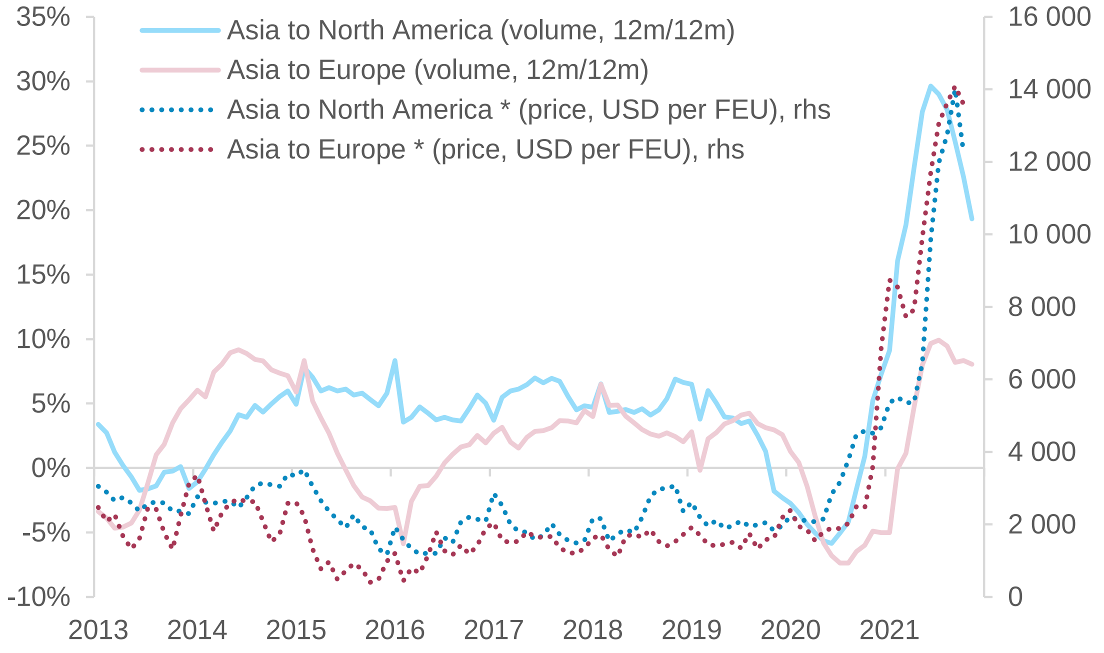
Source: Euler Hermes

We expect global trade in volume to gradually return to its pre-crisis long-term average, with growth at +5.4% in 2022 and +4.0% in 2023.

At a sector level, the 2021 outperformers should continue to see strong exports in 2022 (energy, electronics, M&E). The main export winner in 2023 should be automotive.

Transportation bottlenecks in H2 2022

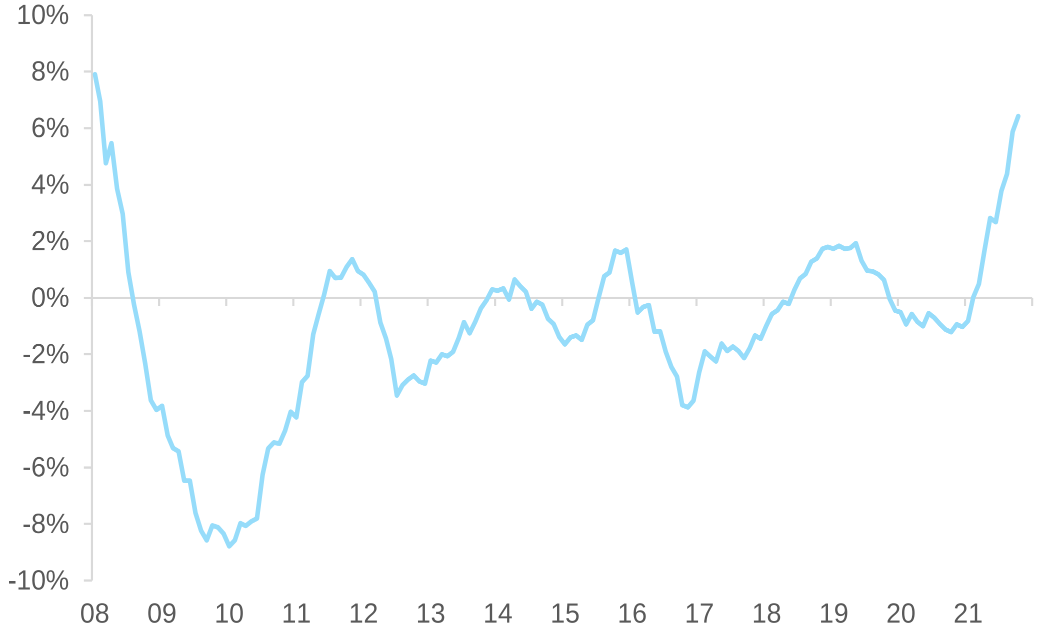
Container prices and volumes by route



Sources: Bloomberg, Euler Hermes, Allianz Research
Note: Data until November

Container prices (Asia-Europe, Asia-North America) peaked, yet remain 6 times above pre-pandemic levels. Less acute shipping congestions in H2 2022 as capacities increase.

New orders of containerships
(12-month rolling sum, as % of existing fleet)

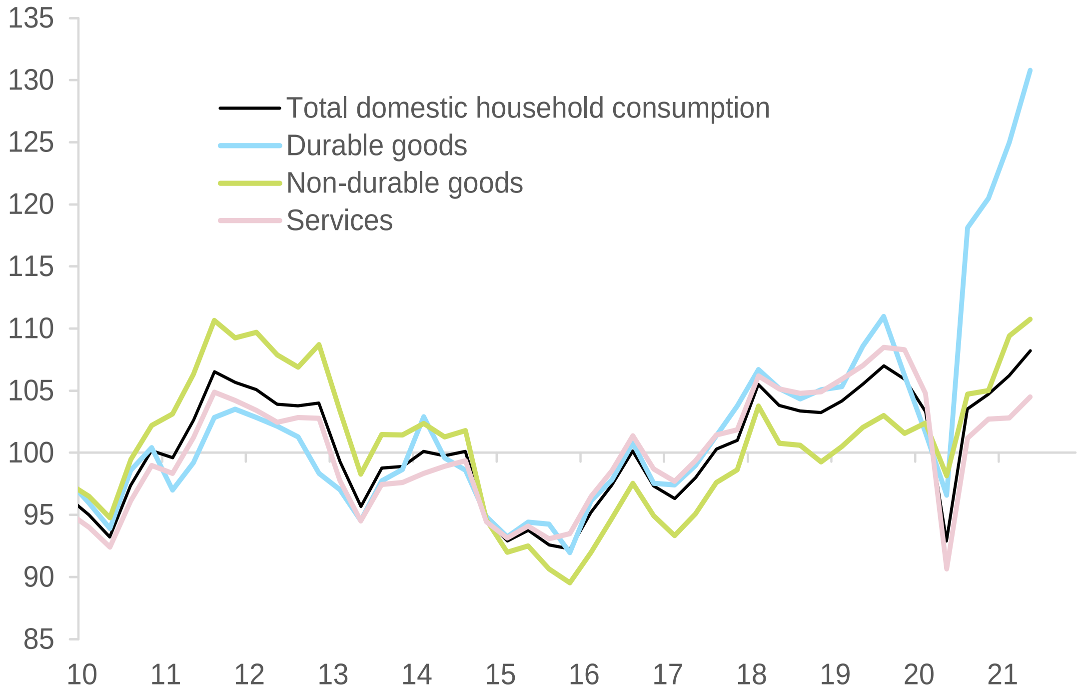


Sources: Bloomberg, Euler Hermes, Allianz Research

Global orders for new container ships reached record highs over the past few months (to 6.4% of existing fleet). The USD17bn port infra plan will reduce global pressures.

Excess savings will support spending

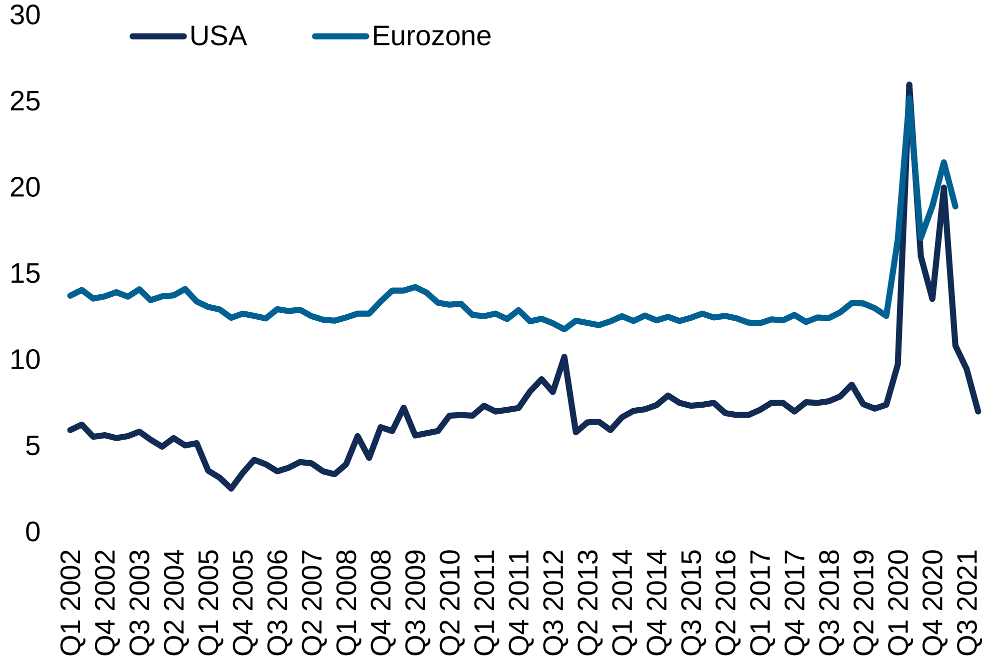
Domestic household consumption in advanced economies



Sources: Refinitiv, Euler Hermes, Allianz Research

Boom in goods demand is bound to slow.

Households' saving rate (% of gross disposable income)



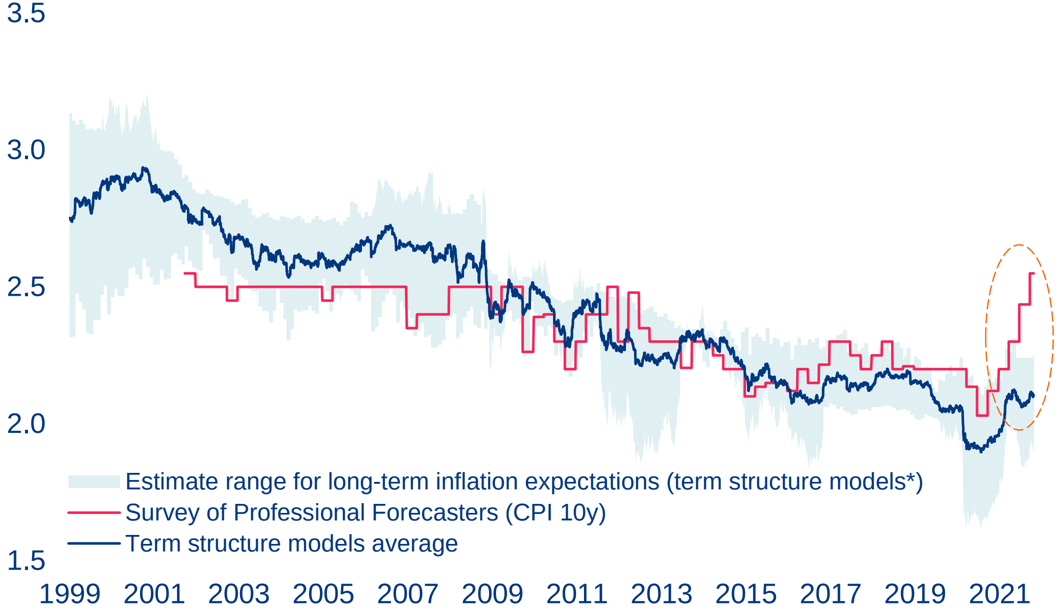
Sources: Refinitiv, Euler Hermes, Allianz Research

High households' saving rate in Europe will boost spending into '22-'23. Lower support is expected in the US given that the saving rate reached its long-term average.

Inflation uncertainty remains high

Someone must be wrong!

(Inflation expectations Markets vs Forecasters)

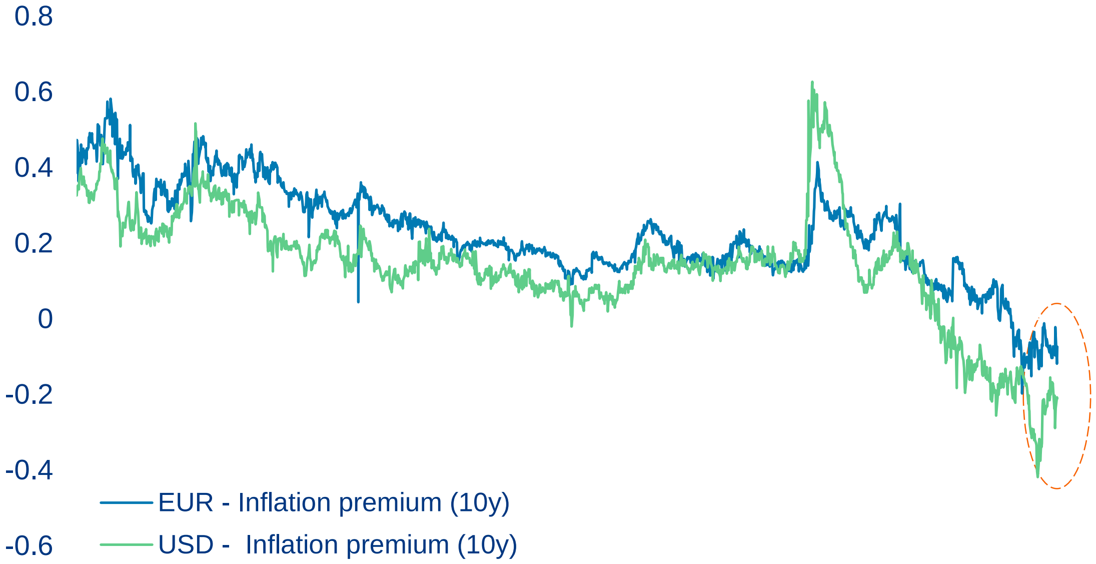


Sources: Refinitiv, Allianz Research
Note: *based on Abrahams and others (2016), D'Amico and others (2017), Christensen and others (2015) and proprietary model.

Strong divergence in inflation expectations of market and forecasters. Are forecasters just following break-evens?

Inflation risk premium bottomed out

(5y5y Inflation swap forward – 10y inflation swap)



Sources: Refinitiv, Allianz Research

Investors still willing to pay a premium for immediate inflation protection. Unusual pattern that starts to revert.

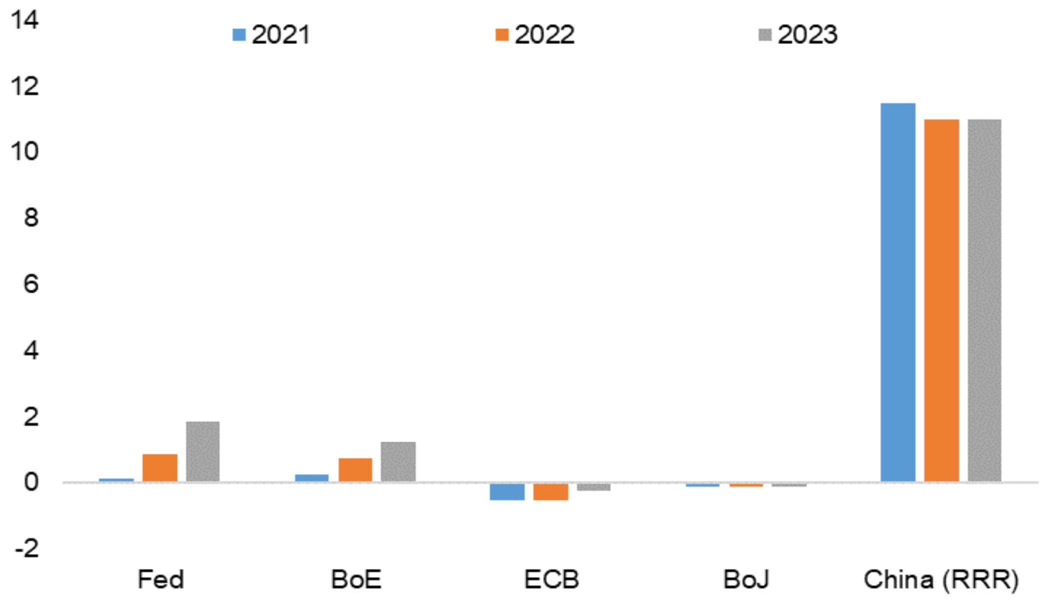
Advanced economies: cautious tightening

Inflation rate forecasts, % (average)

	2021	2022f	2023f
United States	4.7	4.4	2.0
Eurozone	2.6	2.8	1.8
Germany	3.2	3.1	2.0
France	2.0	2.6	1.9
Italy	2.0	2.4	1.3
Spain	3.1	3.9	1.8
United Kingdom	2.5	3.8	2.2
Japan	-0.3	0.8	0.9
China	0.9	2.5	2.0

Sources: Markit, Euler Hermes, Allianz Research

Forecasts for policy rates



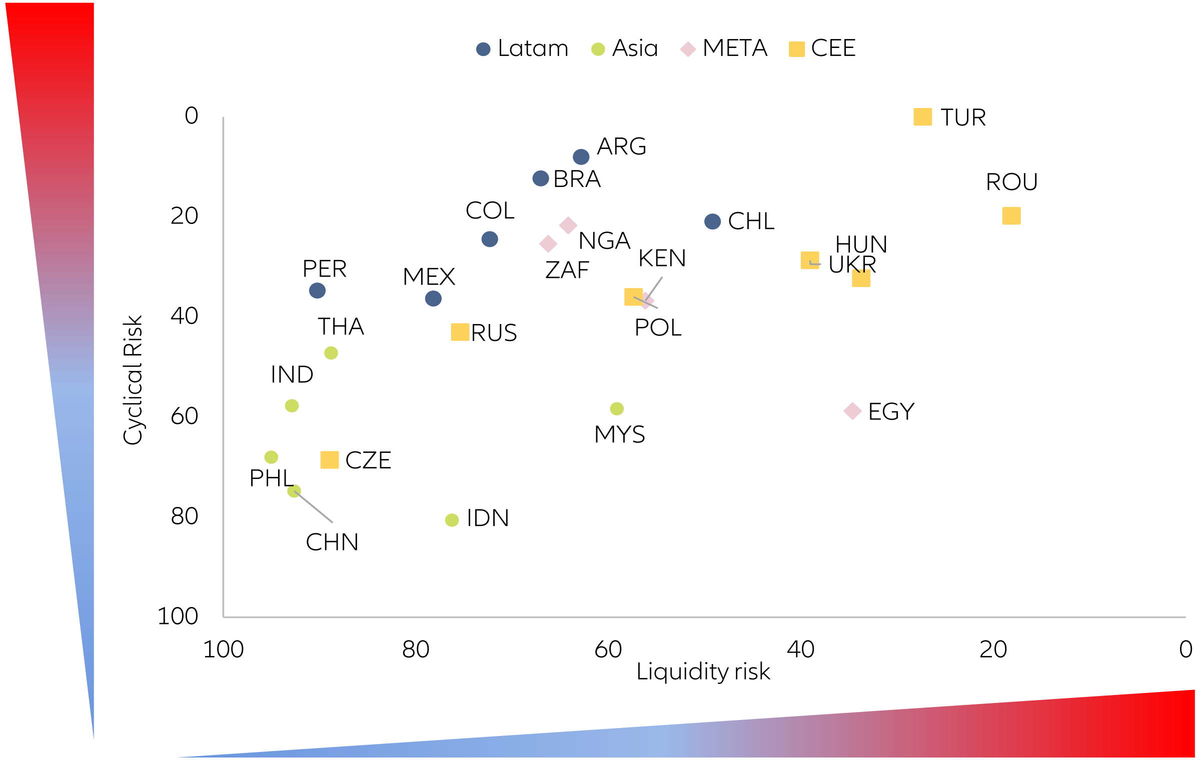
Sources: Euler Hermes, Allianz Research

Inflation proves stickier on the back of multiple bottlenecks to the recovery. US inflation rate to reach 4.4% in 2022 and 2.0% in 2023 (Eurozone 2.8% / 1.8%; 3.8% / 2.2% in the UK).

The Fed is expected to react faster to contain feedback effects from prices to wages. The BoE on a cautious tightening path, the ECB to remain largely dovish.

Emerging markets: more tightening

Liquidity and cyclical risks in EM



EM: Expected policy rates at end-2022

Country	Current policy rate (as of 6 Dec 2021)	Expected policy rate at end- 2022
Argentina	38.00%	
Brazil	7.75%	11.25%
Chile	2.75%	6.00%
Colombia	2.50%	4.50%
Mexico	5.00%	6.00%
Peru	2.00%	3.00%
Czechia	2.75%	4.00%
Hungary	2.40%	3.50%
Poland	1.25%	3.00%
Romania	1.75%	4.50%
Russia	7.50%	6.50%
Turkey	14.00%	18.00%

Country	Current policy rate (as of 6 Dec 2021)	Expected policy rate at end- 2022
China	3.85%	3.85%
India	4.00%	4.50%
Indonesia	3.50%	3.75%
Malaysia	1.75%	2.00%
Philippines	2.00%	2.25%
South Korea	1.00%	1.50%
Thailand	0.50%	0.50%
Egypt	8.25%	9.00%
Nigeria	11.50%	13.00%
South Africa	3.50%	4.50%

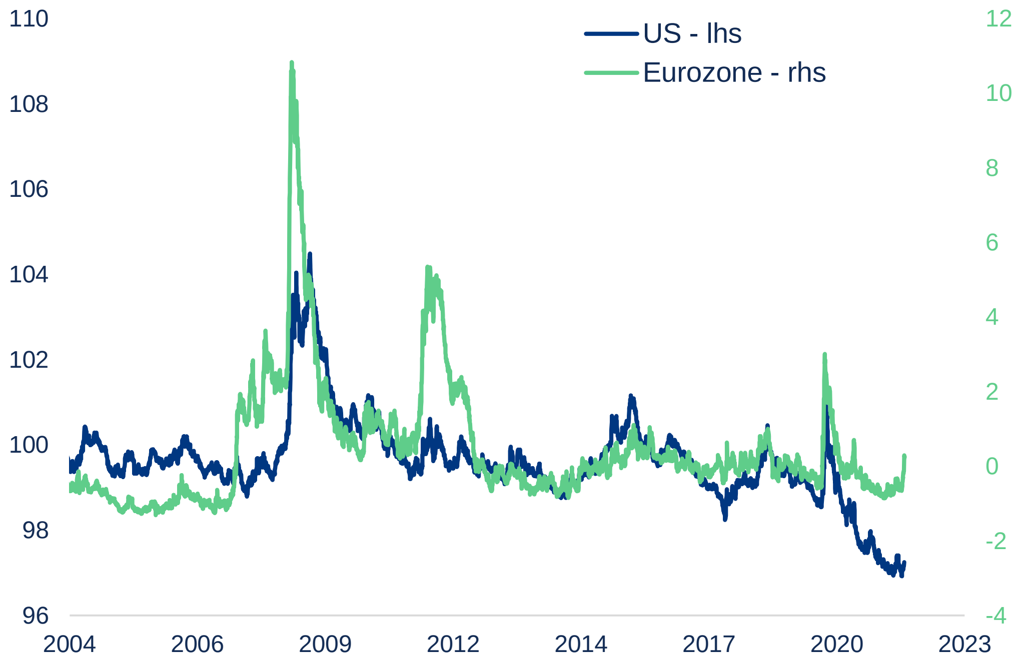
Source: Allianz Research forecasts

Ten EMs are most at risk from a faster-than-expected US monetary tightening: Argentina, Brazil, Chile, Egypt, Hungary, Nigeria, Romania, South Africa, Turkey, and Ukraine.

Monetary policy cycle continues to tighten in 2022. While rising policy interest rates will put a break on recovery in EMs, their effectiveness in taming inflation is limited.

Fiscal policy: diverging paths …

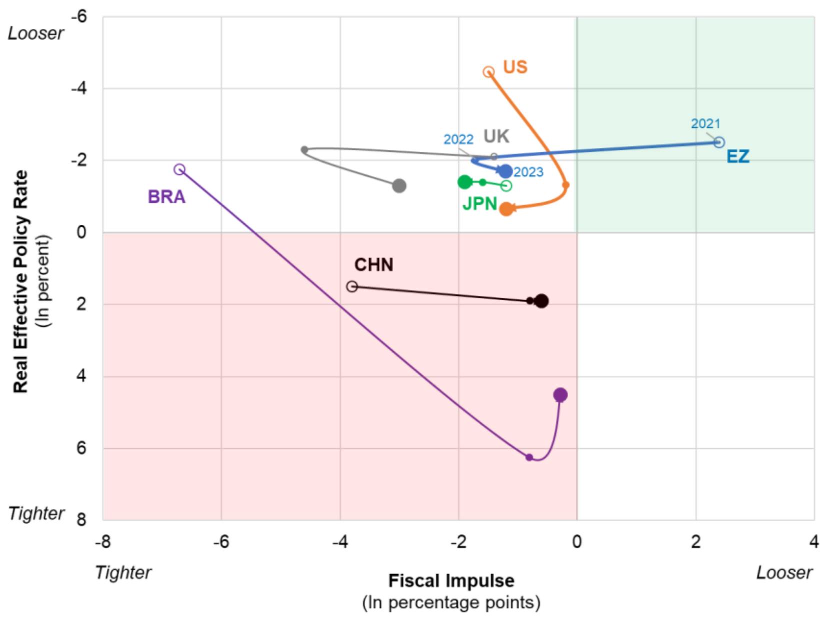
Financial conditions index – Eurozone vs. USA



Sources: Bloomberg, Allianz Research

Financial conditions remain broadly accommodative in the US and the Eurozone, at least until 2023.

Current/expected monetary and fiscal stance (2021-24)

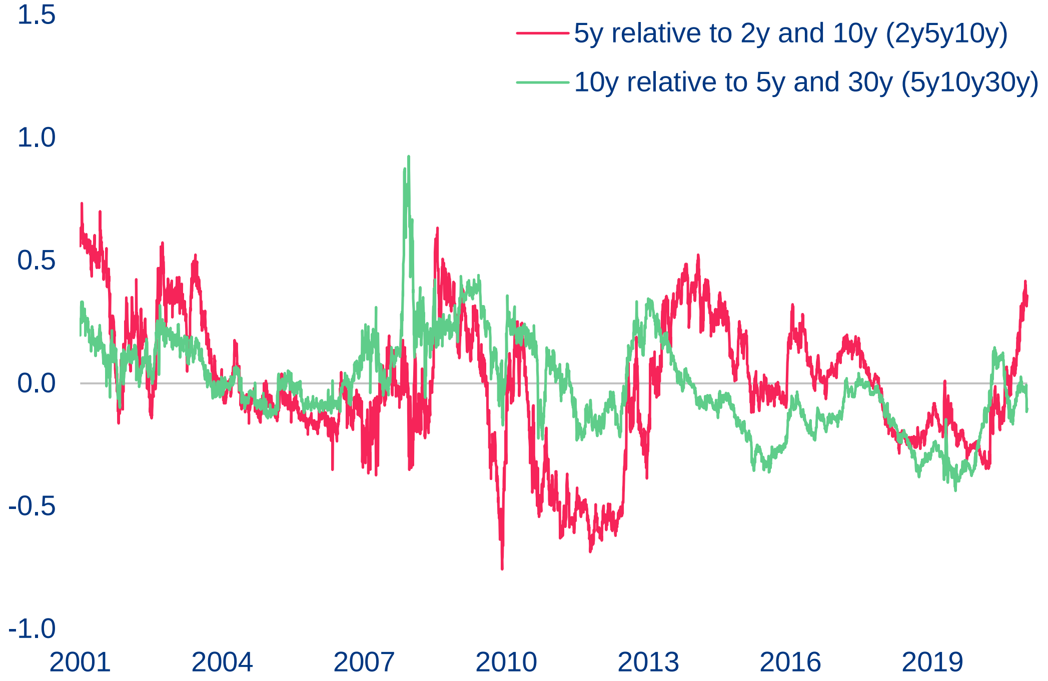


Sources: Euler Hermes, Allianz Research

As monetary policy starts normalizing, the pace of fiscal consolidation will be key: negative impulse in all large economies (but EMs emerging sooner from consolidation).

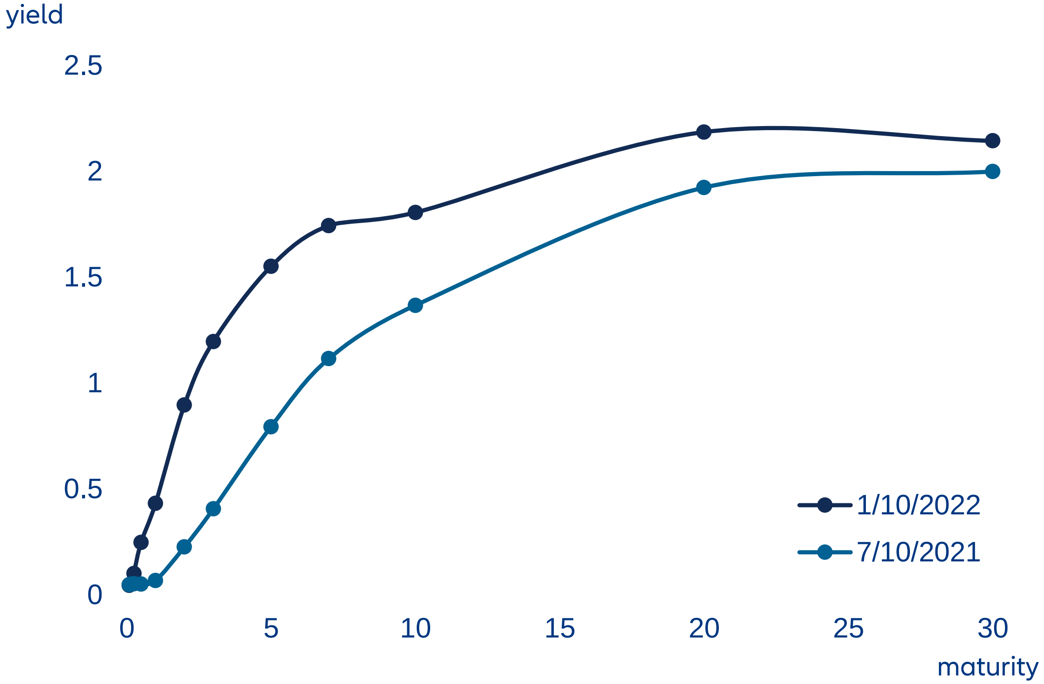
“Belly Dance” in the US

5y tenor gets the hiking heat



Source: Allianz Research

The curvature of the US term structure



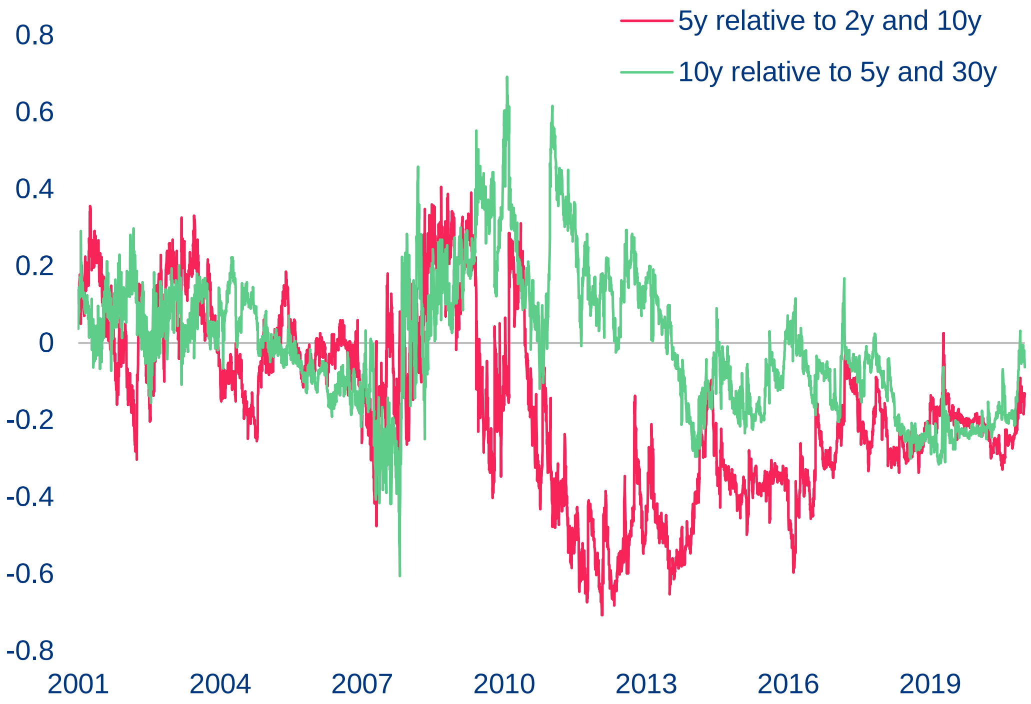
Source: Allianz Research

The 5y tenor will show what prevails: short-term hiking pressure or long-term economic skepticism.

Opposing forces - short-term inflation pressure vs long-term skepticism push up yields in 3-5y segment

“Big Flat” in the Eurozone

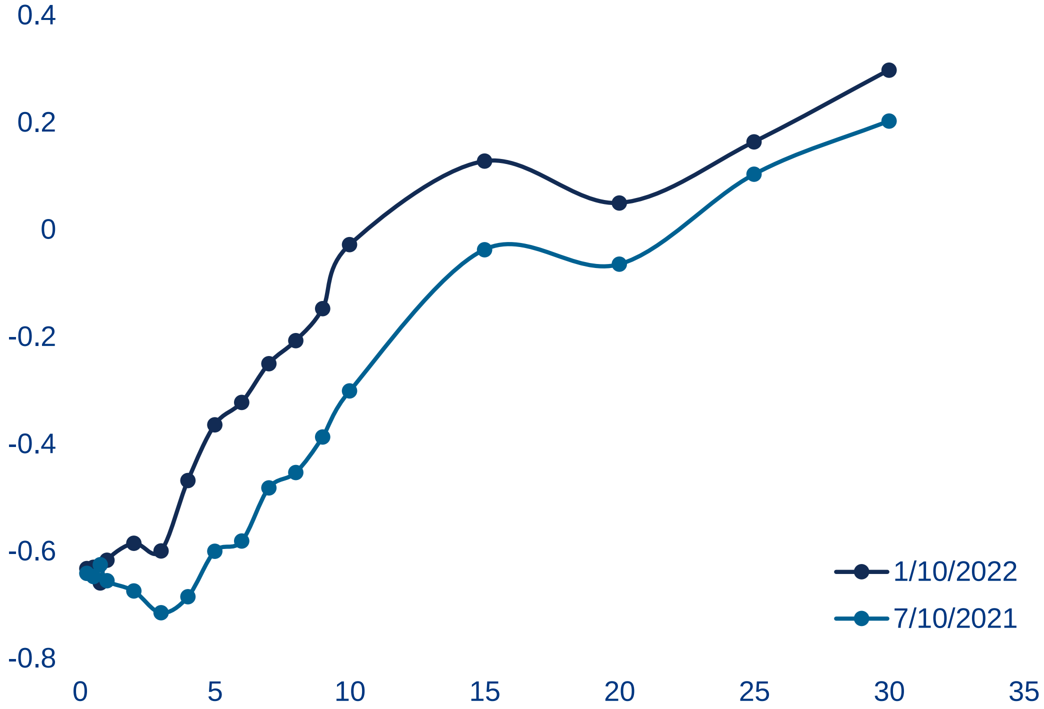
Limited reshaping of the curve



Source: Allianz Research

No significant curvature pressure arising from repricing hiking cycle at the short end of the curve.

Low for longer narrative remains in place

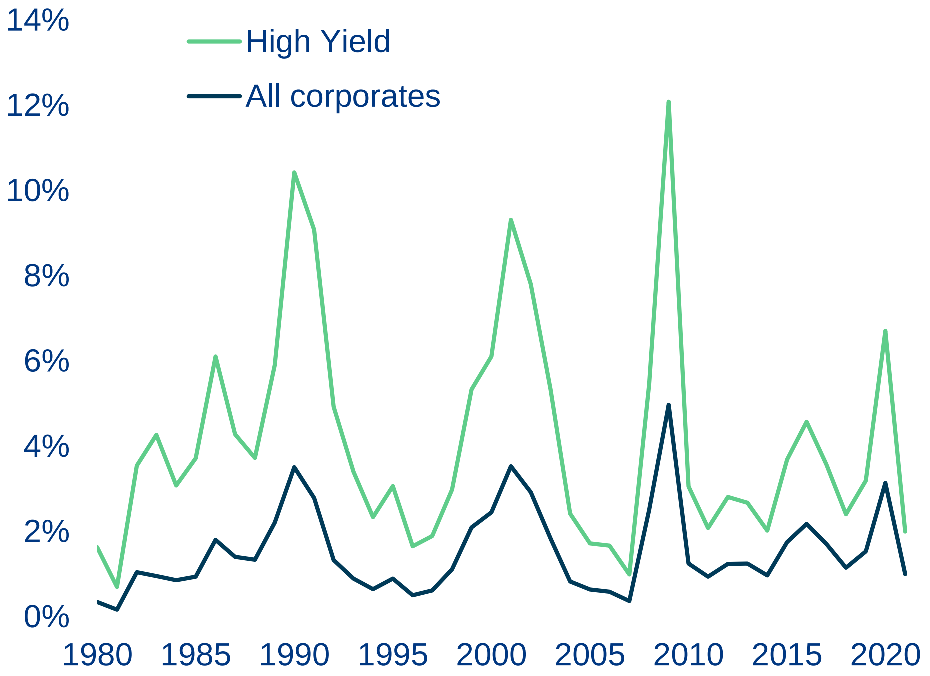


Source: Allianz Research

Omicron uncertainty as amplified increasing skepticism at the long of the curve.

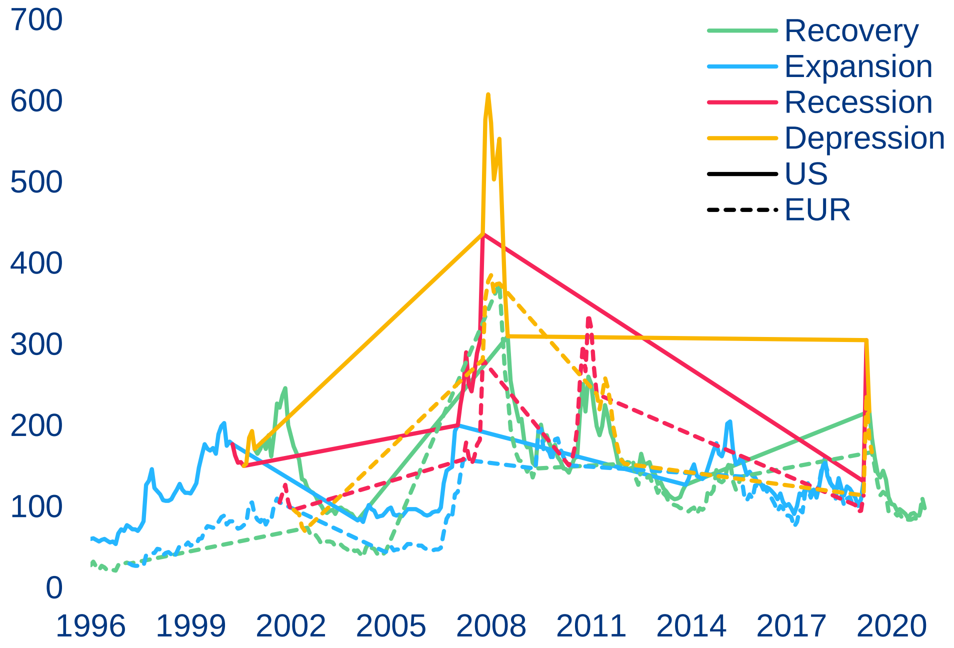
Defaults likely to stay low

Default rates for corporate bonds (in %)



Sources: Moody's, Allianz Research

IG spreads throughout the cycle (in bps)



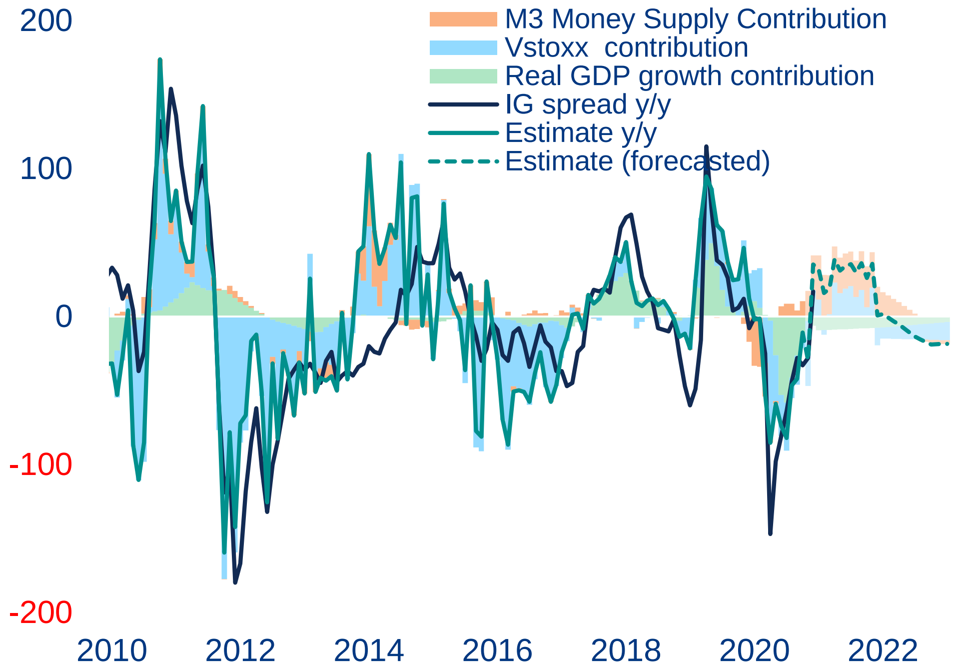
Sources: Refinitiv, Allianz Research

Corporate default rates are set to stay low and increase mildly within our forecasting horizon, especially if extra-ordinary support measures are extended.

The latest spread behavior suggests credit markets may be entering into the expansionary phase of the business cycle, indicating that markets are stabilizing.

Corporate: little upside

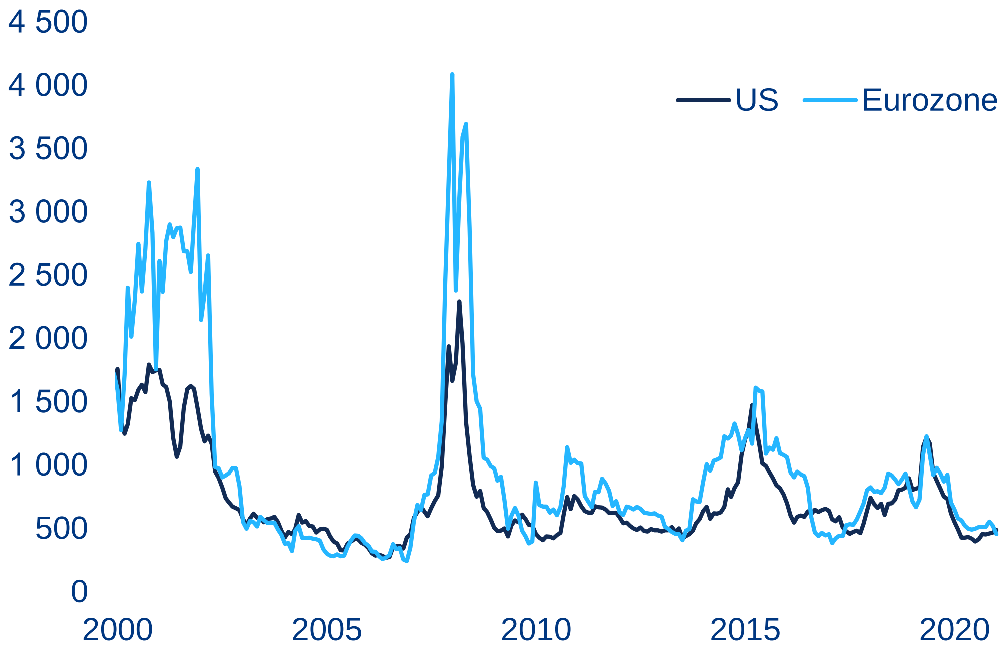
EUR IG corporate spread decomposition (in y/y)



Sources: Refinitiv, Allianz Research (IG: Investment Grade, HY: High Yield)

The predicted slowdown in money supply could result in a ~35bps spread widening in 2022. US investment grade spreads are likely to follow the same trajectory.

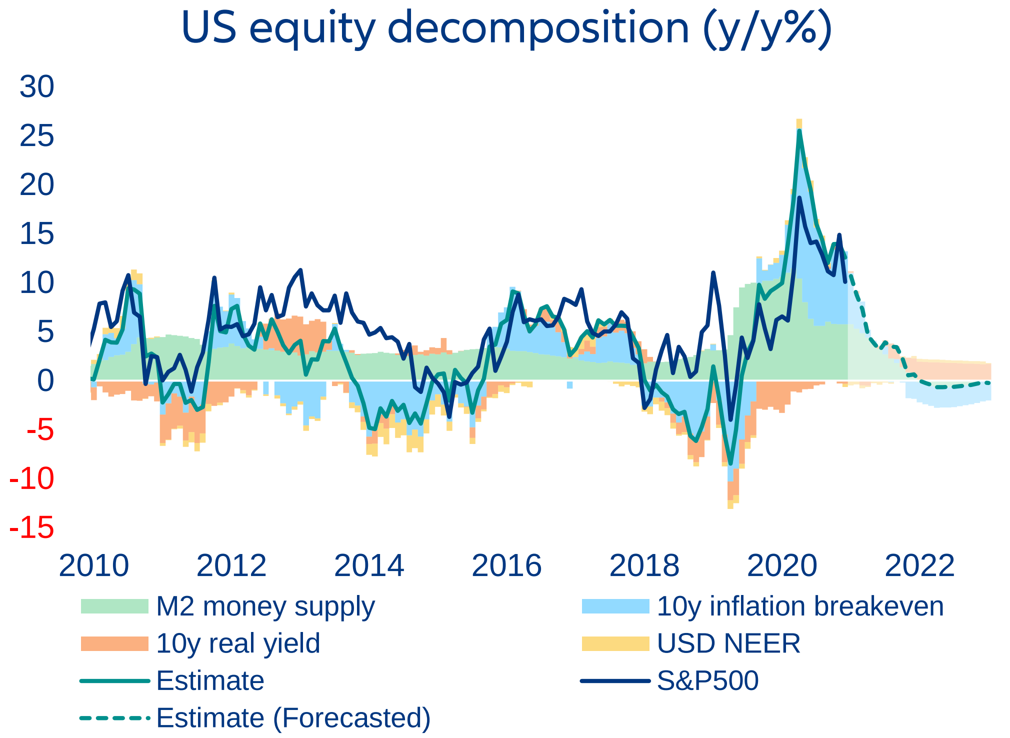
Corporate spread (BB to CCC-rated, in bps)



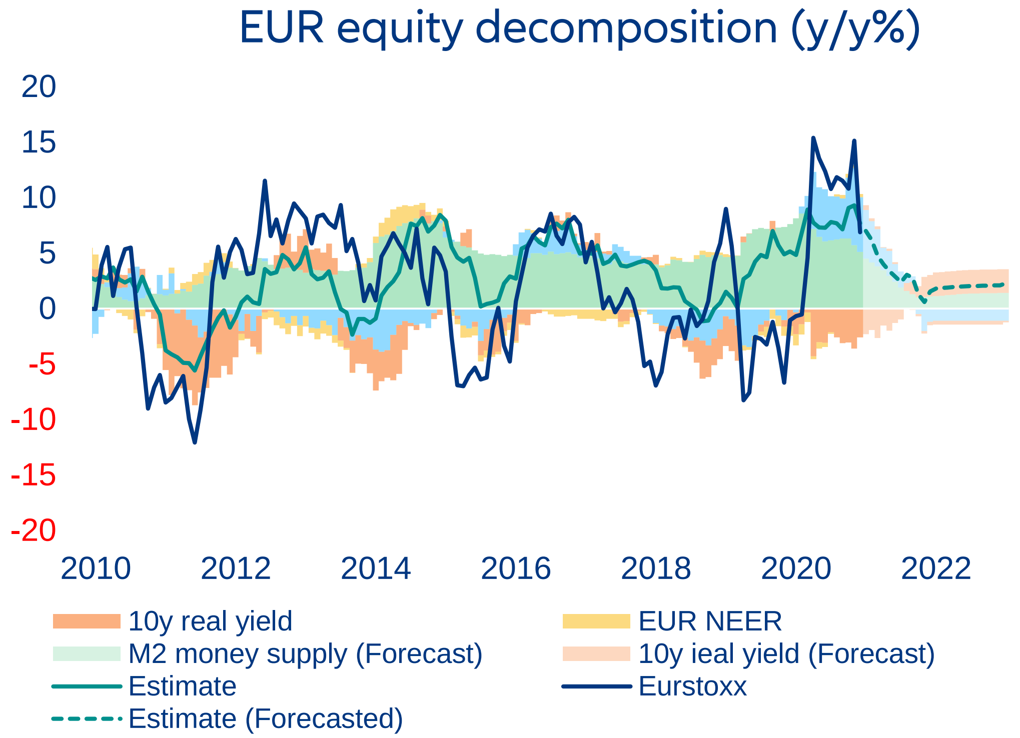
Sources: Refinitiv, Allianz Research (IG: Investment Grade, HY: High Yield)

Credit risk differentials remain at all time lows within the high yield rating bucket as a combination of inflows and monetary policy support has broken risk metrics.

Equities: macro situation less supportive



Sources: Refinitiv, Allianz Research



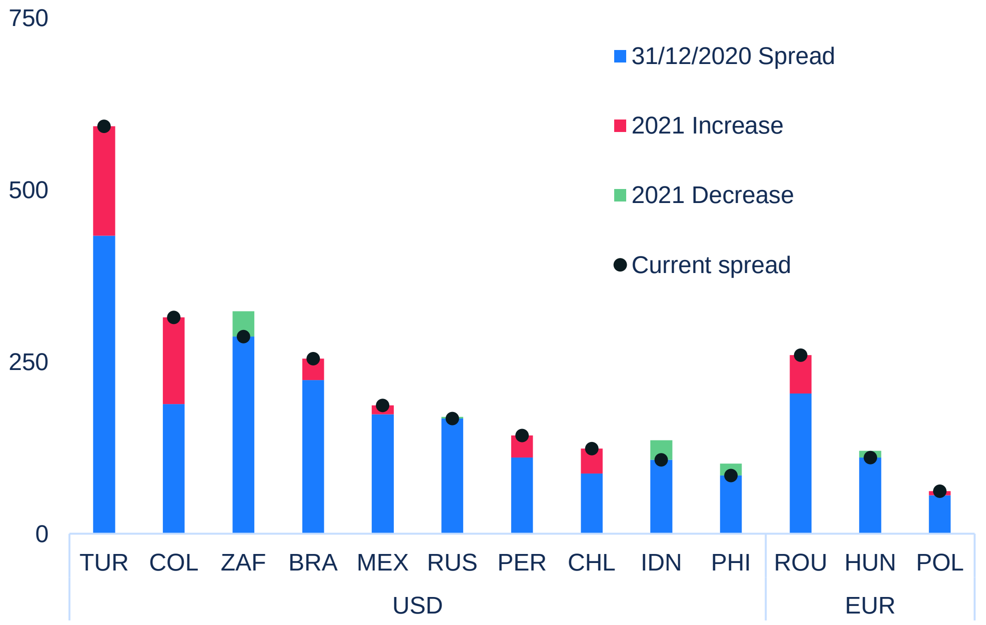
Sources: Refinitiv, Allianz Research

Economic consensus does not indicate a positive outlook for US equity markets. Our decomposition shows flat markets both in 2022 and 2023.

In the case of the Eurozone, the "lower-for-longer" monetary policy consensus will limit the deceleration to +2% return in 2022 and 2023.

EM sovereigns: HY up, LC stabilize

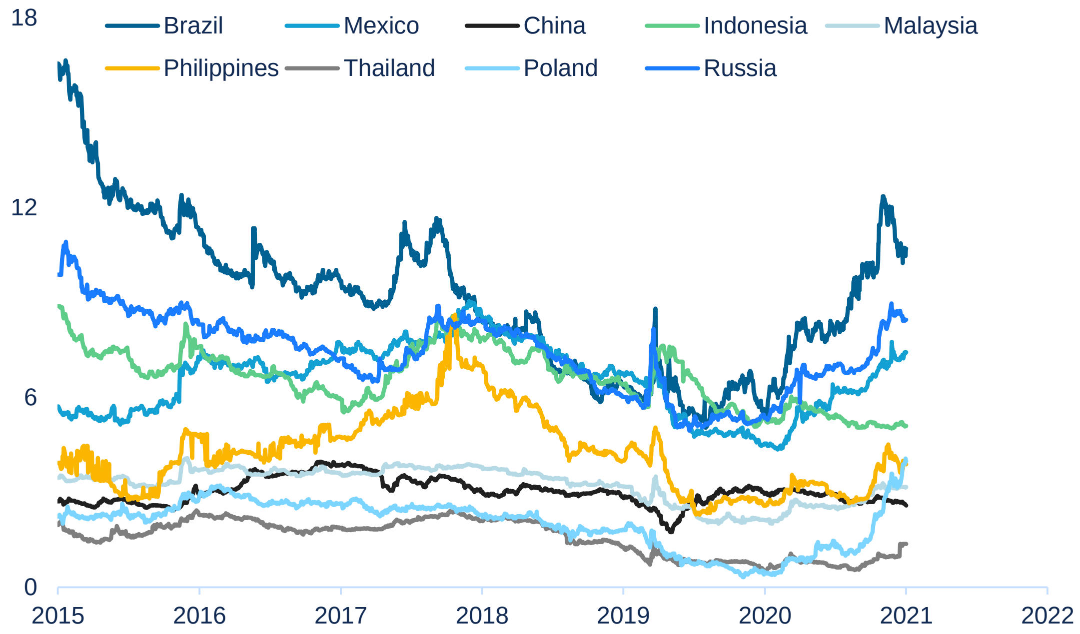
Sovereign spreads widening in 2021



Sources: Bloomberg, Refinitiv, Allianz Research.

As in 2013, the expectation of higher FX pressures and US tapering has created greater EM sovereign spread volatility, especially Brazil, Chile, Turkey, and Ukraine.

5Y Local Yields in selected EM

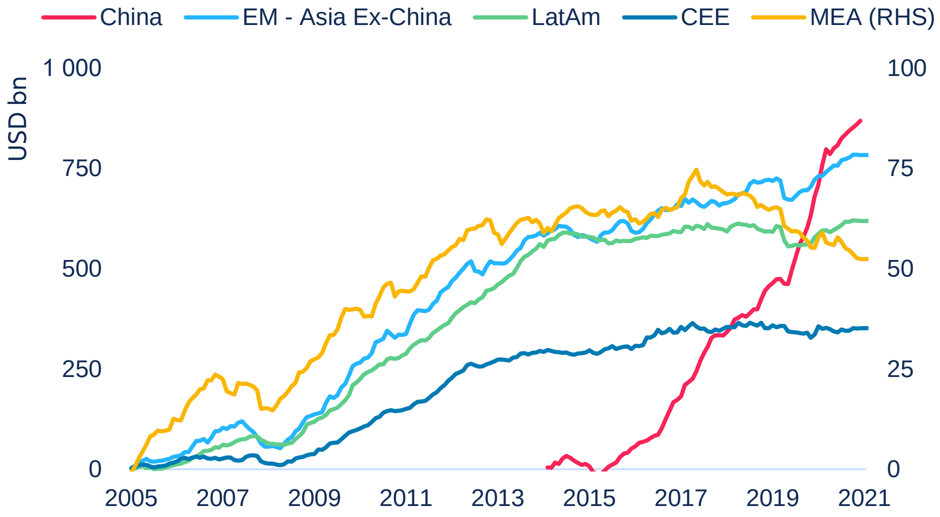


Sources: Refinitiv, Allianz Research

Already at the end of 2021, even with the continuation of hikes, EM curves have started to flatten. We expect this evolution to continue in most countries.

EM capital flows: remain broadly stable

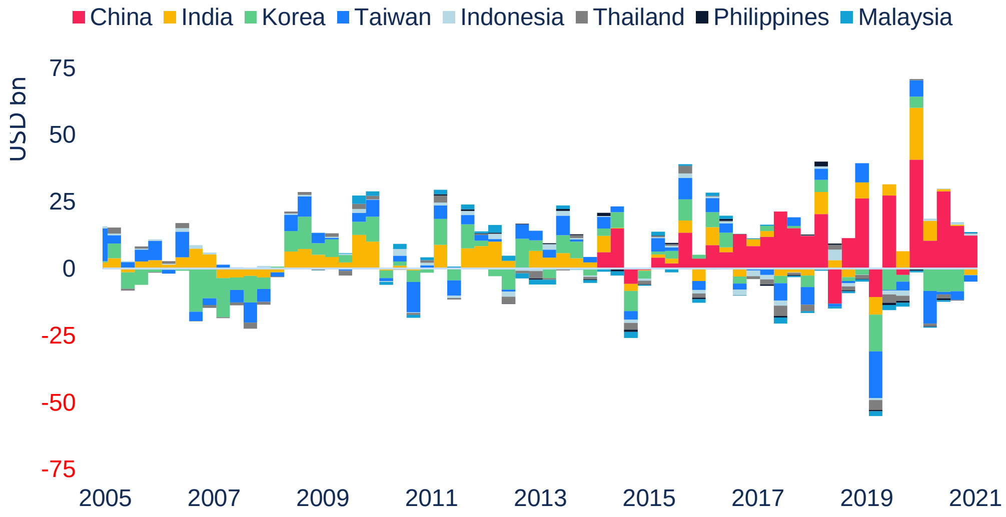
EM capital flows (equity and debt), cumulative (2005-21)



Sources: Sources: IIF, Allianz Research. EM-Asia Ex-China includes: IND, KOR, IDN, THA, PHL, PHL and MYS. LatAm includes: BRA, CHL, MEX and COL. CEE includes: POL, CZE, HUN, TUR and ROU. MEA only incudes ZAF.

Rising capital outflows from EMs could pick up if external pressures increase. Net capital flows (equity and debt) have generally plateaued.

Non-resident equity flows into Emerging Asia



Sources: Refinitiv, Allianz Research.
Note: HY credit (foreign-denominated).

China and India have led the post-Covid recovery, while two other important markets, Taiwan and South Korea, have had a second tough year.

Thank you!