ECONOSIGHTS

with Diana Mousina

AMP

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Five New Year's resolutions for 2023

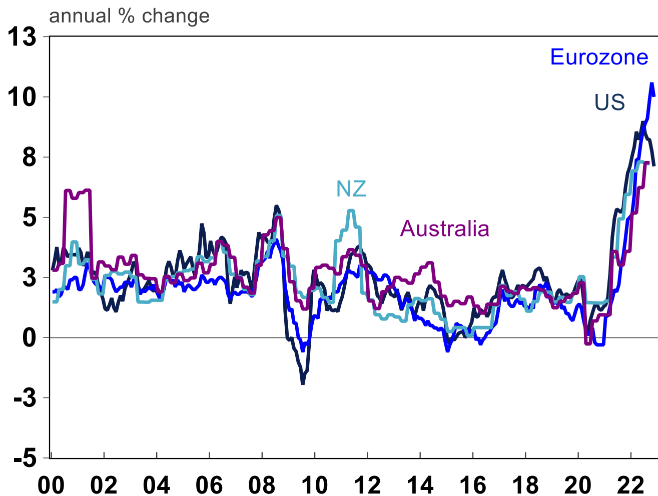
Key points

- Our list of five New Year resolutions for financial markets includes lower inflation (especially in services), a slower pace of wages growth, a pause in central bank rate hikes, a slowing but not a crash in growth and an easing in global tensions.

Introduction

We have put together a list of five New Year "resolutions" for financial markets.

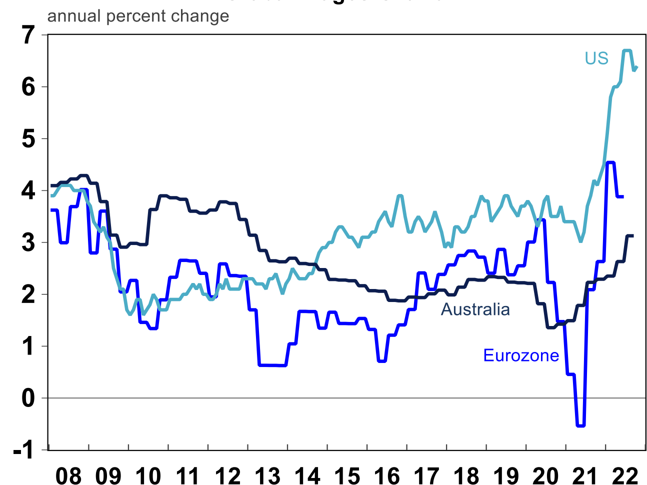
1. Lower inflation, particularly in services



Source: Macrobond, AMP

Global inflation reached multi-decade highs across the major advanced economies in 2022 as goods prices accelerated (from Covid-related supply disruptions, increased demand for goods and commodity price shocks) and services prices followed suit (also driven by a lift in wages growth from an ultra-tight labour market, an increase in transport costs from the global re-opening and a surge in rents). US inflation peaked at 9% in June, Eurozone at 10.6% in October and Australia is likely to reach 7.5% over the year to the December quarter. The high inflation environment this year was the catalyst behind aggressive central bank interest rate hikes. An easing in the pace of inflation will give room for the central banks to further slow the pace of tightening (the Reserve Bank of Australia already reduced the pace of tightening at the October meeting to 0.25% from 0.50% in prior months and the US Federal Reserve hiked by 0.50% this week after lifting interest rates by 0.75% for the last four meetings) before an eventual pause to interest rate hikes in the new year (most likely by the end of the first quarter). Most inflation indicators are trending *down*, a sign that global inflation will come down in 2023. Goods related inflation is easing as transport costs have all declined significantly (some to pre-Covid levels), commodity prices are below their early 2022 year highs and central bank rate hikes are slowing consumer demand which will also help to reduce inflation. But, services inflation is still elevated, led by a tight labour market increasing wage costs and rents are still high (although look to be peaking), which are a large weight in the consumer price basket. A continuing slowing in goods prices is likely in 2023 and headline inflation is expected to come down to around 4% or less by late 2023 (but it will vary by country), which is still higher than central bank targets of ~2-2.5% but this is much lower compared to the pace of growth in 2022 and a further decline in inflation is likely in 2024. Lower services inflation would be beneficial in reducing inflation in 2023.

2. Slower pace of wages growth – particularly in the US



Source: Macrobond, AMP

Wages growth picked up significantly in 2022 across advanced economies, in response to higher consumer price inflation and very tight labour markets. Labour markets in the major advanced economies are at full employment. In the US, there are around 1.7 available jobs for every unemployed person and in Australia there is close to 1 open job for every unemployed person. But, labour markets are starting to weaken as growth slows in response to higher interest rates. In the US, initial and continuing jobless claims are rising and counts of job losses are rising. Australia's leading indicators of employment growth are plateauing which indicates some slowing in employment growth in coming months. A slowing in labour market demand would be helpful in reigning in wages growth to more sustainable levels (at around 3-4% per annum). While high wages growth sounds favourable from a consumer point of view, continued elevated wages growth creates too much upside pressure on inflation, which then feeds back into higher wages and can become an unsustainable "wage price spiral". Lower levels of wages growth in 2023 would be more favourable for the inflation outlook. In Australia, wages

growth has been much more moderate compared to global counterparts (because there has also been a lift in the *supply* of labour while other countries like the US have seen a fall in labour supply) and is currently at 3.1% (year on year) and is expected to reach 3¾% by mid-2023, which is not excessive.

The most favourable outcome for the economy would be a weakening in labour demand that would first lower the level of job openings before the unemployment rate increases. This should decelerate wages growth as labour demand slows. However, the high level of job openings could also reflect job mismatches in some economies, especially in countries like the US where labour supply did not rise back to its pre-Covid levels as many older workers decided to take an early retirement. In this case, the only way to reduce wages growth will be to lift the unemployment rate. A rise in the unemployment rate is likely in 2023, but the key will be to limit its increase. In Australia, we expect the unemployment rate to reach 4% by late 2023 (its currently at 3.4%).

3. A pause in central bank rate hikes

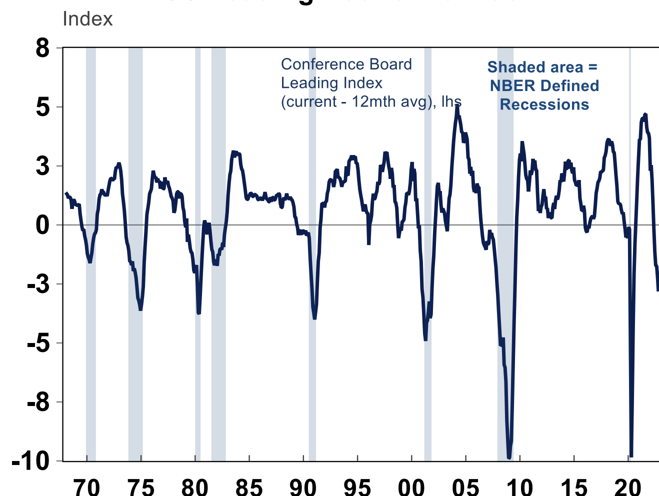
Some central banks are now slowing the pace of interest rate hikes, after significant interest rate increases through the year. We expect most major central banks to deliver a few more rate hikes early next year (see the table below) but the anticipated slowing in inflation (see Part 1), lower economic growth and a weaker labour market in 2023 should see most major central banks ease the pace of tightening in early 2023 before an eventual pause in the rate hiking cycle. A lower pace of inflation alongside less interest rate hikes would set a positive environment for sharemarket returns and would mean less risk of a central bank overtightening in 2023. However, if inflation remains persistently high then a slowing in the pace of rate hikes would not be desirable.

Country	Interest rate start of 2022	Interest rate end 2022	Interest rate mid-2023 (forecast)
Australia	0.1%	3.1%	3.1%
US	0-0.25%	4.25-4.5%	4.75-5.00%
New Zealand	0.75%	4.25%	4.75%
Canada	0.25%	4.25%	4.50%
UK	0.25%	3.50%	4.00%
Eurozone	0%	2.50%	3.00%

Source: Bloomberg, AMP

4. A slowing in economic activity, but not a crash or recession

US leading indicators (like the Conference Board Leading Economic Index which includes things like building permits, ISM new orders index, jobless claims, S&P500 index and weekly manufacturing hours worked as well as the inverted yield curve – see the chart below) are indicating a very high chance of a US recession in the next 12-18 months. Central banks are trying to achieve a softening in growth and consumer spending to get inflation down through increases to interest rates. The problem is that historically, a slowing in economic growth without a serious contraction or recession has been difficult to achieve when interest rates have been tightened significantly. We expect GDP growth to slow considerable across the major economies in 2023, with a forecast for global GDP of 2.5% (which is very low, usually global growth is around 3%). While the risk of a recession is very high in countries like the US and Eurozone we see central banks pausing on rate hikes sooner than expected by financial markets (see point 3) which should reduce the risk of a large growth slowdown. A large downturn would mean further downside to sharemarkets as earnings growth would decline sharply from current levels.



Source: Macrobond, AMP

5. An easing in global tensions

Geopolitical risks have been very high in recent years, as the global economy moves into a more multi-polar world as China increases its economic dominance relative to the US. The US recently issued new export laws that prohibits US companies from exporting any semiconductor chips or equipment used to make semiconductors to any Chinese company (which was done to curb the Chinese semiconductor industry). So the battle between the US and China around technology will remain an issue for years. But, tensions are likely to simmer away, rather than get worse. China would likely want to avoid conflict with Taiwan after witnessing impacts to Russia this after the invasion of Ukraine, the Russia/Ukraine situation isn't likely to become worse and in 2023 there are no major global elections which can cause volatility in markets. Geopolitical tensions and uncertainty tend to be negative risk events for markets, so an easing in geopolitical risk would be favourable for sharemarkets.

Source: Macrobond, AMP

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