The 9 things to watch in 2023

Key catalysts for the economy and markets

February 2023

Summary

Every year we compile a list of “9 things to watch”, not in the belief that we will get everything correct, but to focus attention on the factors that will decide the fate of markets this year and provide a benchmark against which we can monitor developments. This year, our list focuses on monetary policy here and in the US, key elements of the US economy, Australian wages and house prices, China as a bright spot of global growth and US-China relations. Table 1 on page 2 outlines *The 9 things to watch* for the year ahead and we explore each item in following pages.

> **Why predict?**
> Robert Armstrong, *Financial Times* writes: The point of making predictions is “to clarify and crystallise our current thinking about the market. Predictions also create an opportunity for accountability.
>
> We all struggle under 2 powerful cognitive illusions. Looking forward, we think we can see the future better than we actually can. Looking back, we think we did predict the future better than we actually did. Making predictions helps control these twin biases.”

US interest rates and economy

What consequences will be felt in 2023 from last year’s aggressive tightening by major central banks around the world? With the US Federal Reserve the most aggressive of the major central banks in lifting interest rates, investors globally will look to the US to see the effects of that tightening.

This focus means that several of our “9 things to watch” for 2023 revolve around how the tightening might impact the US economy. We expect to see a hard landing with unemployment rising sharply. Indeed, we believe that a material rise in unemployment is needed to reduce wages growth back to a level that is consistent with the Fed’s inflation target.

While headline inflation may decline surprisingly swiftly this year as some of the price rises we saw during the pandemic are reversed, we expect that Fed policymakers will increasingly focus on achieving a sustained decline in inflationary pressures.

That means wages growth must fall; we think the US central bank will be reluctant to cut interest rates before there is clear evidence that wages growth has slowed. If that is the case, then the market’s persistent hopes for rate cuts in the second half of 2023 might be dashed.

Lower inflation also means less pricing power for US companies. That suggests that US corporate earnings will fall by more than 10%, which would also be a nasty surprise for investors.

Key things to watch in Australia

Wages growth will be key for the Reserve Bank of Australia (RBA). Unlike the US, however, the current pace of Australian wages growth is consistent with sustained low inflation. The challenge for the RBA then is to prevent wage growth from accelerating too far, rather than to reduce it. The current level of interest rates should be successful in limiting the pick-up in wage growth to around 3.5% over 2023, and if that pans out, the RBA may be able to begin cutting interest rates towards the end of this year.

Rate cuts may also be justified by the state of the housing market. Australian house prices started falling in 2022 even before the RBA began raising interest rates and that will be a drag on consumer spending as well as construction. While some analysts hope that prices will stabilise as soon as the RBA stops lifting interest rates, we suspect that prices will remain soft throughout the year.

China a bright spot in the global economy and China – US relations

China looks set to be one of the few bright spots in the global economy in 2023 now that COVID restrictions have been removed and macroeconomic policy settings are becoming more stimulatory. While stronger Chinese demand could boost global inflationary pressures, the prospect of no further shutdowns, leading to a more reliable supply of goods from China, might be more important. Finally, we think that US politicians will continue to impose sanctions on more Chinese firms as geopolitical tensions remain fraught.

Summary of key things to watch 2023

Table 1: The 9 things to watch in 2023

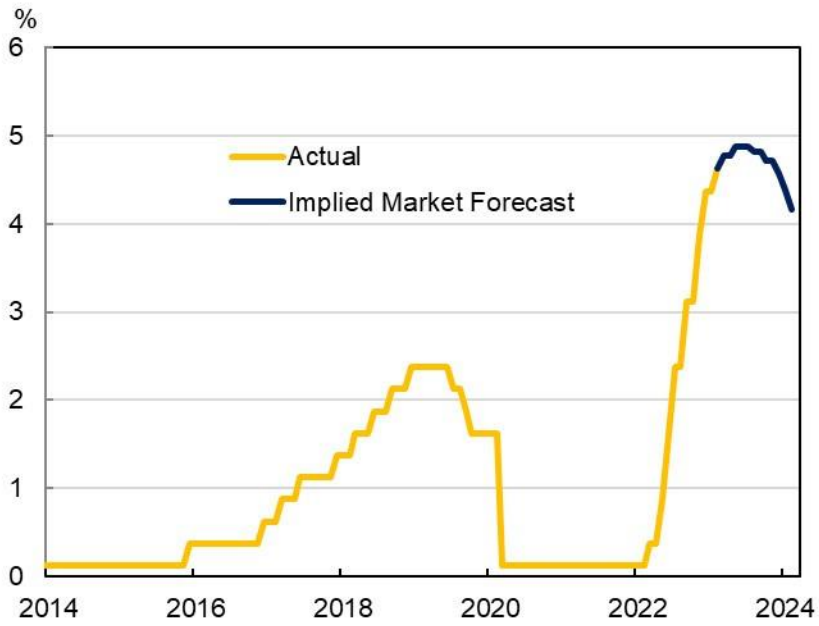
Item	Forecast
1. Monetary policy	The RBA pivots in 2023; the Fed doesn't
2. US economy	Experiences hard landing
3. US unemployment rate	Rises above 6%
4. US inflation	Headline inflation falls more quickly
5. US corporate earnings	Falls more than 10%
6. Australian wage growth	Rises to 3.5%
7. Australian house prices	Remain weak in 2023
8. Chinese growth	Business investment at 6% or more
9. US-China relations	US will impose more sanctions on Chinese firms

Source: TCorp

1. The RBA pivots this year; the Fed doesn't

Central banks in most developed economies aggressively raised interest rates over 2022 to combat high inflation. The US Federal Reserve (Fed) expects its key policy rate to reach 5.1% by the end of 2023, up from 4.25-4.5% currently. In contrast, financial markets expect the Fed policy rate to peak just below 5% before it starts cutting rates in the second half of 2023. In fact, the market expects the US policy rate to be below its current level by the end of 2023 as noted in Chart 1.

Chart 1: Market pricing – US Fed funds rate



Source: Bloomberg

Central banks are focused on returning inflation back to target. Of course, aggressive tightening may trigger a recession, but the Fed and European Central Bank appear willing to take this risk. The Bank of England and Reserve Bank of New Zealand are also continuing to tighten monetary policy despite forecasting recessions in their economies. In fact, the RBA is a little unusual in its commitment to keeping unemployment low while still trying to reduce inflation.

This raises an important question of how long central banks will keep interest rates high before they begin easing. Clearly the market thinks the Fed will quickly shift from tightening to easing policy. But even if inflation is falling towards the Fed's 2% target in 2023, we don't think policy will be eased this year. Policymakers would be concerned about cutting interest rates before wage growth has decelerated to a level consistent with 2% inflation, and that seems unlikely to occur before 2024. An unexpectedly large rise in the unemployment rate is the key factor that could change the balance of risks and prompt the Fed to cut rates sooner.

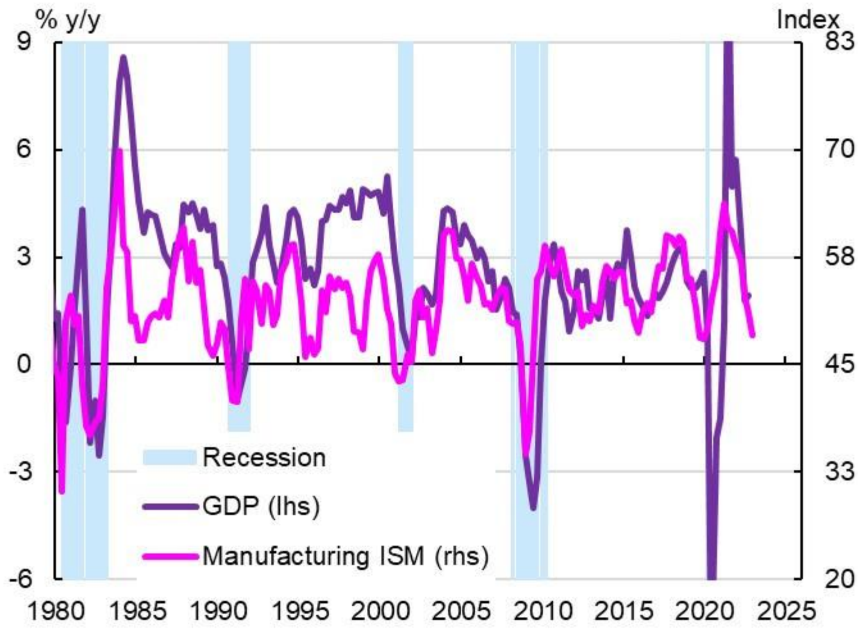
In contrast, we think that the RBA will start cutting interest rates at the end of 2023 – sooner than the market currently expects. If wages growth remains contained and inflation returns towards its target range – which we think will be the case – the RBA is unlikely to keep rates high amid rising unemployment and slowing economic activity. With inflation falling and long-term inflation expectations remaining well-anchored, the RBA Governor at the time is likely to pivot the focus of monetary policy to supporting growth and limiting the rise in unemployment.

2. US economy experiences hard landing

Everybody agrees that US economic activity will slow in 2023 but there remains an active debate about whether its economy will experience a hard landing (i.e., recession) or a soft landing (low but still positive growth). Last year, former Fed Vice-Chair Alan Blinder introduced a new term into the debate: a 'soft-ish' landing. He argued that while soft landings were very rare, soft-ish landings – where production falls marginally and for a short duration – were far more common.

For 2023, the consensus seems to be anchored to the view that the US economy will experience a soft-ish landing. For example, a Bloomberg survey of 56 forecasters in January 2023 found that the median expectation was for annual GDP growth to slip to -0.1% in the second half of 2023 before rebounding in 2024. Thus, while it is unusual for so many analysts to be forecasting a recession, it is even more surprising that they are so confident that it will also be mild.

Chart 2: US economy and manufacturing



Source: Bloomberg

Many indicators that have preceded recessions in the past – such as the inversion of the yield curve and weak business surveys – are flashing red at present, which probably explains why a recession is anticipated. That doesn't explain why so many analysts think it will only be a shallow downturn, particularly given how aggressively interest rates have increased.

In our view, underestimating the role of lags in monetary policy may be contributing to this opinion. That is, even though interest rates rose a lot over the second half of 2022, aggressive tightening doesn't truncate the time it takes for those higher rates to affect the housing market, construction, spending and employment. The magnitude of the increase in rates, however, does suggest that when the impact becomes apparent it will be sizeable.

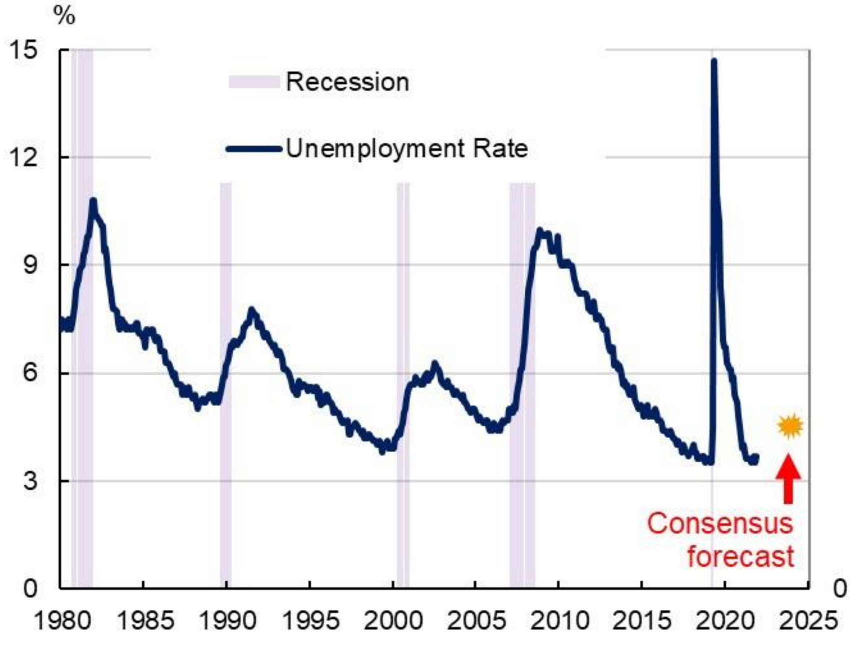
Of course, the US economy does not appear to have the same financial imbalances that were present before the Global Financial Crisis, which does suggest that when policy is eased, the US will emerge from recession more quickly than from the GFC. There is, however, one other reason why analysts may be anticipating a shallow downturn, which is if the unemployment rate remains low, despite the economy falling into recession. We discuss this issue next.

3. US unemployment rises above 6%

While forecasters place a 68% probability of the US economy experiencing a recession in 2023, they also expect it to be very shallow. Moreover, the unemployment rate is only expected to rise a little and remain below 5%. As shown in Chart 3, such a modest rise in the unemployment rate resulting from recession would be unprecedented.

Of course, this time may be different because those firms that have struggled to fill vacant positions in recent years may hoard labour during the impending downturn. In this scenario, however, wage growth will likely remain strong and be inconsistent with inflation falling back to the Fed's 2% inflation target. And that would be a problem for the US central bank.

Chart 3: US labour market



Source: Bloomberg

Fed policymakers – as with most central banks – have made it clear that reducing inflation is their number one priority. They have argued that low and stable inflation is a *prerequisite* for a sustained strong labour market. Faced with the situation where wages growth (and hence inflation) remains uncomfortably strong, it seems clear that they would be compelled to raise interest rates higher than markets currently expect to ensure that production falls, unemployment rises even further and wage pressures are extinguished.

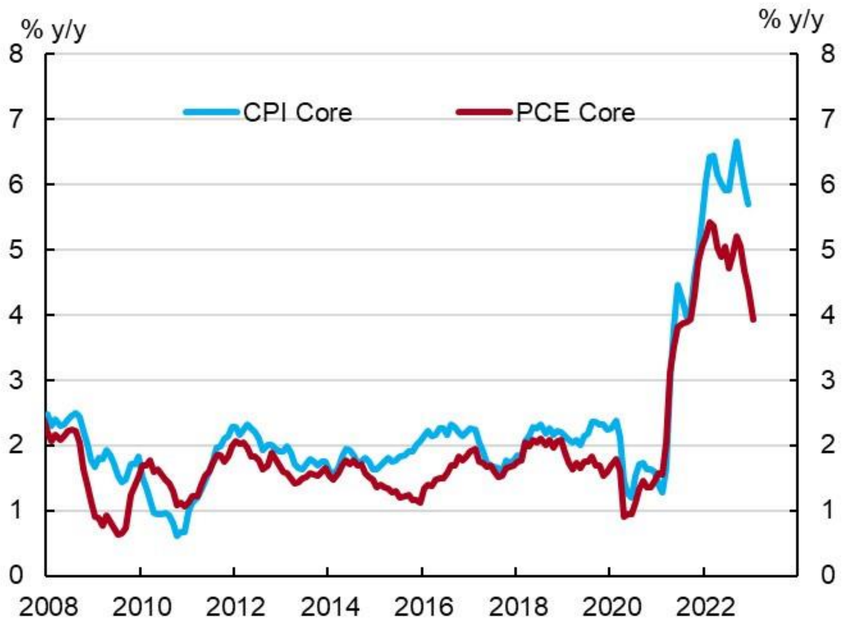
It is also possible – although we consider it unlikely – that the nexus between wage growth and inflation could be broken. That is, inflation declines even as wages growth remains strong. This, however, would require firms to accept a large decline in profit margins and earnings, a possibility not supported by the recent actions of a range of high-profile US firms – including Microsoft, Meta, Amazon, Goldman Sachs, Citi, CNN, PepsiCo and Netflix – which have all announced layoffs over the past 6 months. Moreover, as we will see in our discussion of US corporate earnings, it is also not factored into analysts' earnings expectations.

4. US inflation falls sharply due to transitory factors

Fed policymakers expect inflation to fall to 2.8% by the end of 2023 and then decline to 2.3% over 2024, which is obviously close to – but still above – their 2% inflation target. Market sector economists expect a very similar outcome. The outlook for inflation is important because Fed officials have also said that they plan to keep interest rates high until they are certain that inflation is returning to target. Taking these comments literally implies that interest rate cuts are unlikely to be on the table at least until the second half of 2024.

That said, inflation does appear to have peaked in mid-2022 and recent monthly inflation data has been quite subdued. So, could the deceleration of inflation occur more quickly than policymakers or analysts currently expect? We think there is a good chance that it will, and US inflation ends 2023 at 2.5%. Even if this occurs, however, we suspect that some Fed policymakers will remain reluctant to start cutting interest rates this year, and to understand why that may be, we also need to look at what factors are currently driving inflation.

Chart 4: US inflation



Source: Bloomberg

First, some developments that boosted inflation in 2021 and 2022 – such as surging freight costs and higher commodity prices – have already started to reverse. Second, as supply chains normalise, the production of many goods, such as motor vehicles, is returning towards pre-pandemic levels just as policy tightening starts to weigh on demand. As such, the prices for these items are also now falling and dampening inflation. Together, this means that even if the underlying inflationary pulse remains at around 3%, it's quite plausible that reported inflation falls well below that, at least for a period.

Of course, this is where it starts getting tricky for Fed policymakers. Although they have justified rate hikes on the back of actual inflation readings, they may be reluctant to cut interest rates quickly in response to weak inflation readings if wages growth hasn't slowed. And slower wage growth is necessary to be confident that inflation will remain low.

5. US corporate earnings fall more than 10%

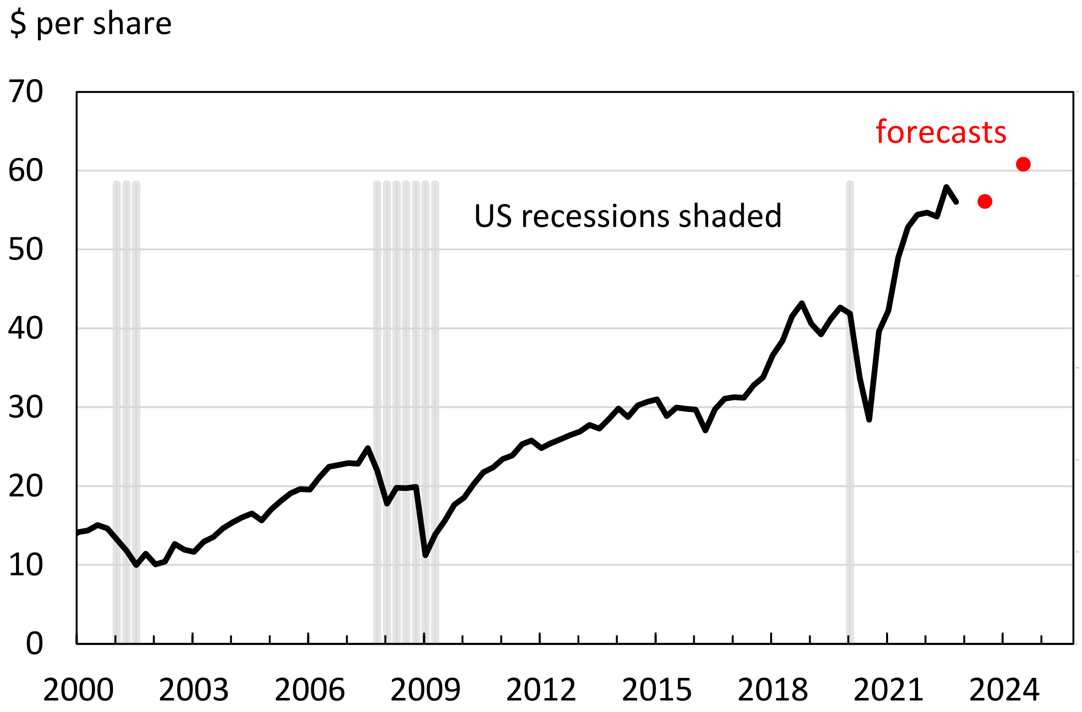
US corporate earnings growth has been very strong in the past decade, supported by rising margins, falling debt costs, lower taxes and modest wage growth, as well as higher leverage. These previous tailwinds which supported earnings are now becoming headwinds and raises the question of how weak US corporate earnings will be this year.

The current consensus expectation is for earnings to hold steady in 2023. This forecast implies that the US economy will slow, but will still experience a soft landing. While economists expect a 'soft-ish' landing, such an outcome would still point to a larger decline in earnings, so can the US economy simultaneously experience recession, falling inflation *and* see earnings not fall?

We think not.

In an environment of falling inflation, downward pressure on profit margins will weigh on earnings. Firms will then cut costs in response, including labour costs, leading to a rise in unemployment and a further weakening of economic activity. Chart 5 shows that earnings have fallen notably in recent US recessions, with historical experience suggesting that earnings decline by around 15% in a typical recession.

Chart 5: US corporate earnings



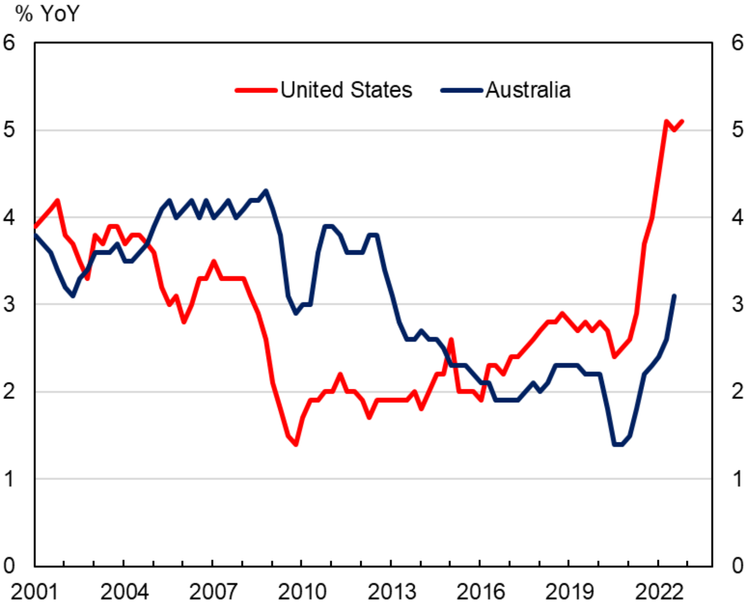
Source: Bloomberg

This also underscores our view that the current consensus/market earnings forecast for 2023 is overly optimistic. We expect earnings to fall this year by more than 10%, consistent with our belief that the US economy will slow and unemployment will rise.

6. Australian wage growth reaches 3.5%

One of the key differences between the inflation outlooks for Australia and the US is the recent behaviour of wage growth. In the US, wage growth accelerated to levels that are not consistent with inflation sustainably returning to around 2%. In contrast, Australian wage growth is still consistent with low inflation. While the challenge for the RBA is to prevent wages growth from accelerating too far, the US central bank has a much more difficult task; it needs to reduce labour demand sufficiently to lower wage growth. That is one of the reasons why we think a recession in the US is likely.

Chart 6: Wages growth



Source: Bloomberg

How quickly will Australian wages growth accelerate over 2023? The RBA expects it to peak at 3.9% in late 2023 and continue at this pace throughout 2024. That pace is, at best, consistent with the top of the RBA's 2-3% inflation target but the risk is that if inflation expectations lift and wage growth accelerates, interest rates will have to rise by more than is currently envisaged to contain inflation.

We think wages growth will peak at around 3.5% towards the end of 2023, substantially less than the RBA's forecast. Supporting our contention is the lack of any rising wage pressure in new enterprise bargaining agreements (which contained wage increases of a modest 2.6% throughout 2022). This suggests that many workers do not expect inflation to remain elevated for too long. It's also likely that the next minimum wage rise will be in the 3-3.5% range – lower than the 5.2% delivered in 2022.

Wages growth will also be restrained as the labour market loosens throughout this year and into next year. With population growth increasing again and overseas arrivals already back at their pre-pandemic levels, labour shortages will be alleviated, particularly in sectors such as hospitality and tourism. The slowing in economic activity, as earlier rate rises start to bite, will also weigh on labour demand and help to restore more balance in the labour market.

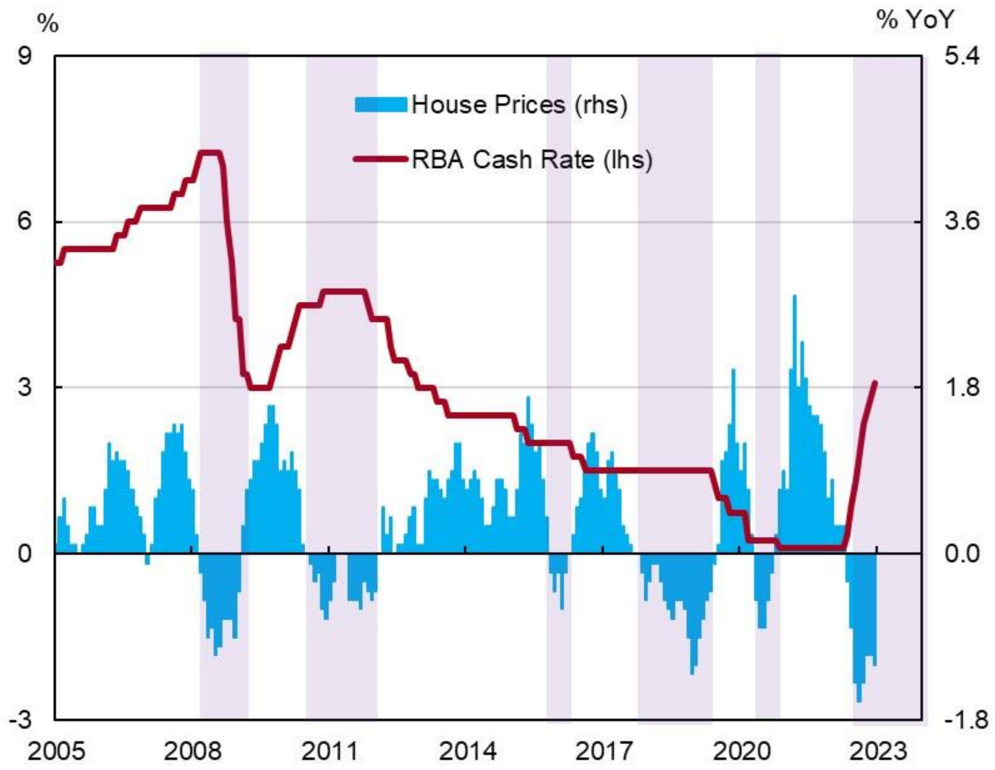
If wages growth can remain consistent with the RBA's inflation target, the bank will have more flexibility than other central banks to respond to a slowing in the Australian economy by cutting interest rates. This will give Australia a decent chance of avoiding a recession this year.

7. Australian house prices remain weak over 2023

CoreLogic estimates that Australian house prices have fallen 8.4% since the RBA began raising interest rates at its May 2022 board meeting and many market commentators expect that prices will ultimately decline by 15-20% during this cycle. While this suggests that analysts aren't being overly optimistic about the near-term path for house prices, there nevertheless appears to be an assumption that once the RBA stops raising interest rates, the housing market will recover.

As shown in Chart 7, however, house prices could remain weak even if the RBA stops hiking rates. The shaded areas show that in 2011, 2016 and 2018, house prices fell even though interest rates were held steady. In 2008-09, prices fell even as interest rates fell.

Chart 7: Housing activity



Source: Bloomberg

The outlook for house prices matters for the broader economy because of the household wealth effect. In 2019, the RBA estimated that a 1% fall in wealth would result in consumer spending falling by around 0.17%. This suggests that the 8% fall in house prices to date will cause a consumer spending drop of around 1 percentage point. Any further fall in house prices from here would result in an even larger impact on spending.

Of course, interest rates are not the only factor that determines prices. The regulatory environment and the health of the economy are also key. For example, the Australian Prudential Regulatory Authority (APRA) currently requires mortgage lenders to factor in mortgage rates 3 percentage points above the prevailing rate when they assess how much someone can afford to borrow. If that threshold was reduced in 2023, it is possible that house prices could start rising later in the year as it would enable people to borrow more. On the other hand, if the RBA began cutting interest rates in late 2023 and that coincided with rising unemployment, a turnaround in house prices could easily be delayed until 2024. Either way, the house price outlook will be important.

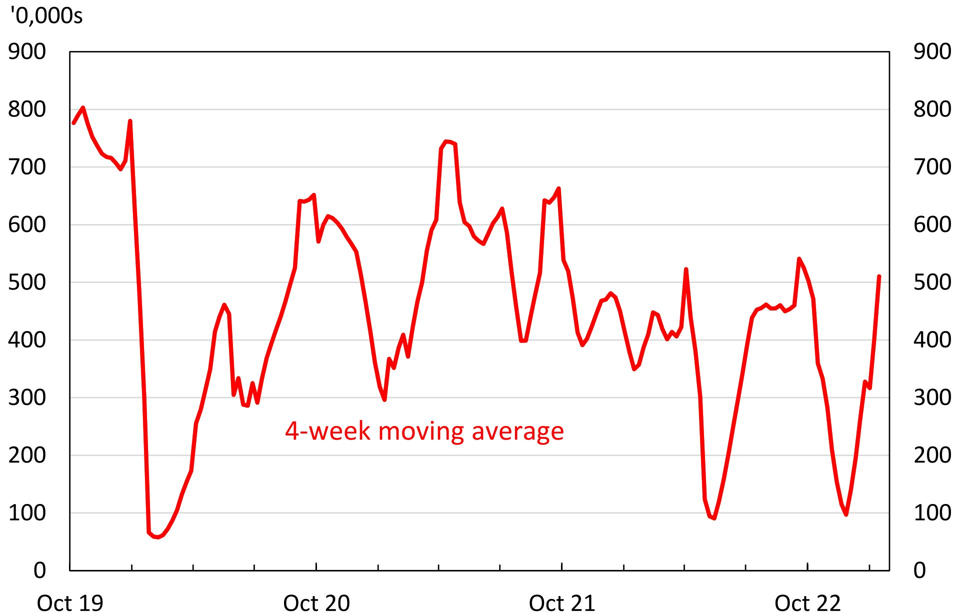
8. China's reopening helps trading partners as much as China

In December 2022, Chinese authorities abruptly abandoned their strict COVID-zero approach and paved the way for a reopening of China's economy. The change occurred amid mounting social pressure and insipid economic growth that failed to meet the authorities' GDP target. So how will the reopening of China's economy affect global inflation and growth?

The shift away from China's targeted lockdowns during outbreaks resulted in a sharp rise in COVID cases. A common view is that widespread COVID infections will weigh on China's economic activity in the first half of 2023 and adversely affect supply chains and could also keep global goods inflation elevated for longer. This mainly reflects staff shortages as people fall ill, affecting both the production and distribution of goods.

On the other hand, disruptions caused by ill health may still have a smaller impact than China's previous approach of frequently locking down entire cities. For this reason, we think the impact of China's reopening on global inflation is unclear, but the impact on growth will be positive. Consensus forecasts are for a healthy rebound in China's GDP growth in 2023, with business investment expected to be 5.5%. We think this could even be stronger, at 6% or more.

Chart 8: Beijing, China weekly metro passenger volume



Source: Bloomberg

Strong pent-up demand from Chinese consumers, especially for services, will support global growth. In particular, the resumption of outbound international travel will boost exports in popular Chinese tourist destinations. This will also lift demand for aviation fuel and provide support to oil prices. The impact on inflation would be at least somewhat offset by the substantial capacity added to the global airline market to meet the higher travel demand, which should see airfares and air freight prices fall.

Overall, we do not expect a big impact on global inflation from China's reopening due to the various offsetting forces. The impact on global growth will undoubtedly be positive – it's simply a question of who benefits and by how much. Countries like Australia that are more exposed to Chinese tourists and students definitely have much to gain.

9. US continues to impose more China sanctions

In December 2022, the US Department of Commerce announced that it had added 36 China-related companies to its Entity List which severely restricts their access to commodities, software and technologies that are important for the development of China's artificial intelligence and advanced computing sectors.

This announcement came just a couple of months after the US imposed curbs on China's access to advanced semiconductors and is yet another example of how the US is attempting to separate its own development from that of China.

The growing number of export restrictions, alongside tariffs on Chinese goods and investment restrictions, shows how geopolitical concerns are becoming increasingly important factors affecting economic development and are increasingly relevant for financial markets.

China, however, has performed several policy pivots over the last year. It not only abandoned its COVID-zero policy and eased restrictions on property development but has also recently adopted a more constructive tone in its foreign relations. Some analysts hope that the return of a more pragmatic Chinese polity could defuse tensions with the West and ultimately trigger removal of some of the restrictions imposed by the US over recent years This would also have some benefit for the US, as lower tariffs on imports from China would assist the US in its fight against inflation.

More likely, in our opinion, is that the US continues to impose more restrictions on Chinese firms and across broader parts of the economy. To understand why this is the case, consider the US House of Representatives, where the Republican Party gained a narrow majority at the 2022 mid-term elections. US politics is currently renowned for how divided the two sides of politics have become, but one area of common ground is China. Both Democrats and Republicans consider China to be a clear and present danger to US security and long-term economic development.

One of the first acts of the new Congress was to create the Select Committee on China, which received overwhelming support (365 votes to 65) including 70% of Democrat members. The Select Committee's purpose is to pursue 'selective decoupling' from China, with particular focus on technology, finance and data. Select Committee Chair, Mike Gallagher, has also nominated strategic supply chain issues as a key area of concern.

What policies might the Select Committee recommend for 'decoupling' US finance from China? Gallagher wants to limit US investment in China and specifically said the committee will develop policies that will 'prohibit state and local pension funds investing in China'. They are also concerned about the transmission of data across borders and how that data might be used by Chinese authorities, which might have implications for Chinese companies such as TikTok, Huawei and ZTE. If these actions are progressed it will obviously be a negative for Chinese financial markets, even if other economies do not follow the US lead. Lower foreign investment in China will also weigh on China's economic growth.

More generally, uncertainty arising from the increasingly unstable relationship between the US and China will reduce investment and global growth. Further, if companies relocate production away from China, it could make global supply chains more resilient but less efficient and may make western nations more inflation prone in the future.

Reflecting on 2022

Just as each year we peer towards the horizon to see what the next 12 months might deliver for investors, we also think it's worthwhile (if not always pleasant) to review last year's forecasts and discover what lessons we can learn. In recent years, there have been no shortage of surprises, and that was true again in 2022 with Russia's invasion of Ukraine, and the very aggressive interest rate hikes by central banks particularly noteworthy.

From last year's list, the key one we got right (at least directionally) was that rising real bond yields would deflate the risk appetite of investors. That said, real bond yields did rise further than we predicted and the negative impact on risk assets was also greater. Our call that Chinese growth would disappoint also turned out to be correct.

In contrast, our prediction that the RBA would not join the Fed and Bank of England in tightening policy was a large miss. US inflation also proved more persistent than we expected, partly due to the Russian invasion and the subsequent surge in oil prices. In recent months, however, US inflation has declined sharply.

In the US, the Republicans did gain a majority in the House following the mid-term elections and they are demanding spending cuts. That said, they certainly did not dominate the election as we thought they would. The post-pandemic economy also continues to take shape and in the US we still haven't seen the return of many of the workers that left the labour market during COVID, which is one reason US wages growth has been so strong.

Meanwhile, as more firms commit to reducing their carbon footprint, the demand for carbon credits continues to rise as we expected and this prompted the Albanese government to impose a carbon price cap. Cryptocurrencies were also in the spotlight in 2022 and, while there was a broad range of regulatory announcements made over the year, regulation itself wasn't the key driver of the huge fluctuations in prices that we saw.

Reflecting on the 2022 list, it is clear that financial markets were dominated by central banks and their response to rising inflation. As we have noted, 2023 will reveal the repercussions of those actions. An interesting question to ponder is whether the last few years have triggered a structural change in the way that central banks enact monetary policy, by being quicker to hike and more reluctant to cut rates. If that is the case, the impact of 2022 may continue to linger over markets for several years.

Table 2: The 9 things to watch in 2022 – forecast vs actual

Item	Forecast for 2022	Actual (year-end)	Outcomes
RBA cash rate	No tightening	Raised to 3.1%	RBA joined global tightening
US inflation	Falls towards 3%	5.5%	US inflation slowed over the 2022H2 but Russia's Ukraine invasion ensured inflation was much higher than expected
Rising real yields deflate risk appetite	Real yield rises to 0%	1.0%	Real yields rose further than expected but did undermine risk appetite
US mid-term elections trigger fiscal tightening	Republicans dominate mid-terms	Republicans gained a narrow majority in House, Democrats retain Senate	Republicans are calling for spending cuts and smaller deficits
New normal for labour force participation	US participation does not recover to pre-pandemic levels	Participation rate was 62.3% – 1ppt lower than pre-pandemic level	US workers have failed to return to the labour market
China growth weaker than expected	2022 GDP growth misses forecasts	China grew by 2.9% over 2022	Chinese growth was particularly weak
Pandemic-driven shifts in mobility have peaked	Rental vacancies trough	Rental vacancies remain very tight	Australia's rental market remains tight but US asking rents are now falling
Carbon price is a catalyst for change	Carbon price keeps rising	Australian carbon credit unit rose from ~$40 to $65	Demand for carbon credits continue to rise
Regulators target crypto-currencies	Bank for International Settlements	BIS introduced prudential guidelines	Regulation of crypto-currencies remains a hot topic

Source: TCorp

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