Five Theories for 2023

Dr. Michael Heise on Global Economics

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High inflation, energy problems, rising interest rates: the past year has demanded a lot from consumers. Which problems will remain, and where are solutions emerging?

2022 was a year that began with many hopes, but in the end brought new burdens and uncertainties. The global political events of the past year will be felt for a long time to come. Will 2023 still be characterized by a kind of normality or are there signs of a turnaround despite the many sources of uncertainty? Here are five theories on this subject.

1. The current pessimism is too high

Of course, the overlapping crises are not yet over and will continue to have a dampening effect on the global economy at the beginning of 2023. However, if we look at 2023 as a whole, we should be wary of excessive pessimism. Numerous burdens on the economy will be offset by stabilizing factors. Of particular importance is the development of energy and raw material prices, which have now corrected significantly following sharp overshoots in early summer and have led to a decline in high inflation rates in most countries. Although, forecast uncertainties are currently very high due to the geopolitical conflicts, new price spikes on the raw material markets are unlikely in the weaker overall economic environment.

Among the factors stabilizing the economy are government relief programs, in some cases on a very large scale, to limit the loss of purchasing power and the cost burdens on companies.

Another factor helping to stabilize consumption is that private households have a high level of accumulated savings from the Covid lockdowns in 2020 and 2021. Additionally, the labor markets in most developed markets also present a robust picture. They are characterized by high demand for labor and declining unemployment compared with the previous year.

2. One will (have to) continue to look strongly in the direction of Ukraine

Despite all the optimism, there are of course also risk scenarios. Strong negative developments could be expected, for example, in a scenario in which the Ukraine war spreads and escalates further, triggering new distortions on the global energy markets. Drastically rising energy prices would fuel inflation expectations and prompt central banks to take further restrictive measures. Recessionary forces would finally gain the upper hand.

However, such a scenario is likely to have a very low probability of occurrence, because an escalation and expansion of hostilities is neither in the interest of the West nor in the interest of Russia, which has so far failed to achieve its military and political goals in Ukraine. On the other hand, a positive scenario could develop if ceasefire negotiations were to take place in the near future. At the moment, this does not seem very likely either. It is conceivable, however, because it is becoming increasingly clear that neither Ukraine nor Russia can fully achieve their goals. If, in the context of a ceasefire, Russian gas deliveries to Europe's previous customer countries were to be resumed, a significant improvement in the economic situation could be expected.

3. Inflation should decline significantly

However, the likely development of the capital markets depends not only on the economy, but also to a large extent on the development of inflation and the course of monetary policy. In the countries of the European Monetary Union, the development of inflation is decisively determined by future energy prices. If the prices of crude oil, gas and electricity remain more or less at their current high levels and do not rise further, consumer price inflation can be expected to fall significantly for this reason alone.

Another factor dampening prices is that supply bottlenecks, which in many cases led to production stoppages and long delivery times during the Covid restrictions, have now receded significantly. Overall, inflation in the European Monetary Union is therefore expected to fall from around 8.5% in 2022 to 6.5% in 2023. In the USA, the relatively low energy prices play a much smaller role. Here, domestic goods prices in particular have risen sharply due to high demand coupled with supply bottlenecks. Inflation in the USA is expected to be around 8% in 2022 and around 4% in 2023. The significant turnaround in monetary policy in the developed countries and many emerging economies is also contributing to the decline in inflation.

4. Further interest rate increases are to be expected for the time being

In recent months, the financial markets have repeatedly speculated on a slower pace or an end to interest rate increases by the central banks, causing bond and equity valuations to rise accordingly.

These interim rallies have proved premature. Central banks will probably want to wait for two or three more months of significantly declining inflation rates - even excluding energy and food prices - before holding out the prospect of an end to interest rate hikes. When this time will come is uncertain. For the time being, further interest rate hikes are to be expected, even if these are always likely to be smaller in the face of weak economic growth. The development of capital market yields and share prices should therefore remain volatile in the coming months. Following the sharp fall in October and November 2022, bond yields are expected to show a slight upward trend in the wake of further interest rate increases by central banks.

5. Capital market prospects favorable again for investors

Following the price declines of 2022, the asset markets are no longer generally overpriced, and the return of clearly positive interest rates is creating investment alternatives. The "investment emergency" of past times, by which was meant the overvaluation of virtually all financial market segments, has largely dissipated. As asset-oriented investments, stocks and shares offer a certain degree of protection against inflation and, despite higher interest rates, offer a risk premium worth mentioning compared with safe bonds. For their part, fixed-income securities have become more interesting again from a yield perspective and they offer a safety buffer with earnings potential in the event of poorer economic developments.

There could also be significant changes in exchange rates in 2023. The euro could make at least slight gains against the US dollar over the year as a whole, as the US Federal Reserve is likely to end its interest rate hikes before the European Central Bank due to stronger declining inflation. It is also very likely that the Bank of Japan will further correct its still very expansionary course and accept moderately rising interest rates, now that inflation rates in Japan have also risen quite significantly and inflation expectations have increased at least moderately. This will stabilize the yen again, which was under strong pressure at times in 2022.

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