Outlook 2023 – Everything alright again?

Dr Jörg Krämer

The financial markets expect the inflation problem to subside in 2023, so everything will be alright again in this respect. Although we expect inflation to remain too high for years to come, we believe there is a good chance that 2023 will be a year of relief on the financial markets. Otherwise, we have revised our 2023 forecasts for Germany and the euro area upward for the first time in quite a while.

Investors expect a better 2023

Stock markets have recovered significantly since September, and Bund yields have settled at a historically moderate 2%. Investors see U.S. inflation having peaked in summer and are extrapolating this positive development into 2023. They expect the inflation problem to subside, the Fed and the ECB to phase out their interest rate hikes in the spring, the economy not to be unduly burdened, and to that extent all will be well again.

We remain inflation pessimists ...

In the long run, we do not believe this narrative. Sovereigns are highly indebted and are pushing their central banks, not only in the euro area, not to raise key interest rates too much, even though people's long-term inflation expectations have already become unanchored. In addition, there are structural inflation drivers such as de-globalization, de-carbonization and the demographic turnaround, i.e. the decline in the share of the working-age population in Europe, North America and China. We continue to expect inflation to average well above the promised 2% in the coming years.

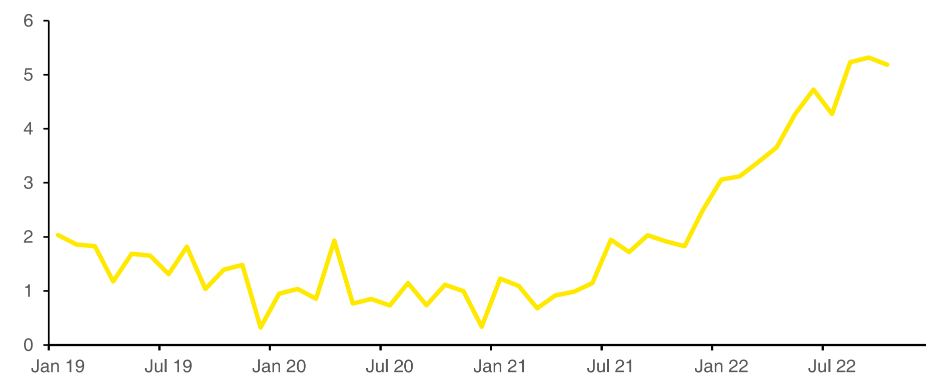
... but inflation will fall in 2023

Nevertheless, the chances are not bad that inflation will fall at least in 2023 and that inflation fears will subside. This is because the contribution of energy to inflation should slowly subside. For example, governments in many euro zone countries have announced curbs on gas and electricity prices. In addition, the oil price is unlikely to rise as sharply next year as it did on average this year. In the euro zone, inflation is expected to halve from almost 11% in the current quarter by the end of next year. The same applies to the US.

Now, it may be argued that core inflation will fall only slightly, especially in the euro area, and will remain stubbornly high because companies have not yet fully passed on the cost boost to consumers and the rise in labor costs will accelerate due to low unemployment. Evaluations of job advertisements, for example, show that companies in the euro area are now offering wages that are a good 5% higher than a year ago (Chart 1).

Chart 1 - Companies in the euro zone entice workers with higher wages

Salary for vacant jobs, change from previous year in percent



Source: indeed, Commerzbank Research

But central banks, which have moved close to governments, and thus also the markets, are more likely to focus on falling headline inflation rate in 2023, taking it as evidence that core inflation will also fall significantly with a certain time lag:

- ***Fed:*** Now that it is becoming increasingly clear that the peak of US inflation is behind us, we expect more than ever that the Fed will raise its key interest rate by only 50 basis points in December rather than 75. For the first two meetings in the new year, we expect steps of 25 basis points each. We continue to see the key US interest rate to peak at 5.0% in spring 2023. Expectations of further falling inflation should allow the Fed to pause for several months. We expect a first rate cut only late next year.

- ***ECB:*** The ECB has recently raised its key rate by 75 basis points twice in a row. For the December meeting, we now expect a rate hike of only 50 basis points (previously: 75 basis points). This is indicated by statements made by numerous Council members. At the beginning of the year, we expect another 50 basis point hike, followed by two more of 25 basis points each. So we continue to expect the ECB to raise its deposit rate to 3.0% by spring. For one thing, influential council members like Villeroy want to keep raising rates until core inflation falls, but we forecast that won't be the case until mid-year. For another, the ECB expects only a mild recession, which it says will hardly lower inflation. After reaching 3.0%, the ECB is likely to pause at this level for a long time. As far as its balance sheet is concerned, the ECB is likely to start reducing its high bond holdings in spring 2023. To this end, it is likely to reinvest only half of the maturing bonds. As a result, the bond portfolio would fall at an annual rate of just 3.5%. With this very moderate pace compared with the Fed, it would show consideration for the highly indebted countries.

Economic situation to ease ...

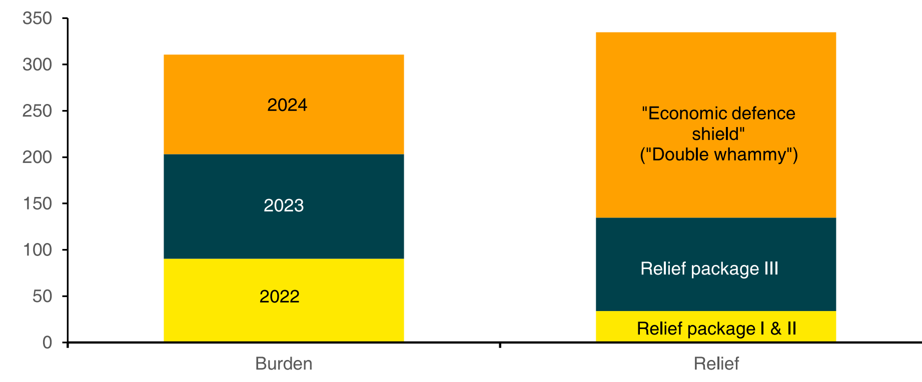
Even though we continue to expect a recession in the first half of the coming year, there have recently been signs of easing that argue against a collapse of the economy in Germany and also in the euro area, as in the financial crisis of 2008/9 or as after the Corona outbreak:

- First, many governments have decided to provide aid to their citizens and companies to cushion the impact of higher energy prices. In the end, for example, the German government's rescue packages are likely to absorb most of the increase in the cost of energy imports (Chart 2). This will stabilize the economy, even

though the packages will put a strain on public budgets and, because they will fuel aggregate demand, point to higher inflation in the medium term.

Chart 2 - State largely takes over increase in energy bill

Burden: increase in cost of German net imports of crude oil and natural gas, from start of 2022 to end 2024 compared with 2021, Commerzbank estimate; Relief: volume of German government aid packages, Ifo Institute estimates, in bn euro

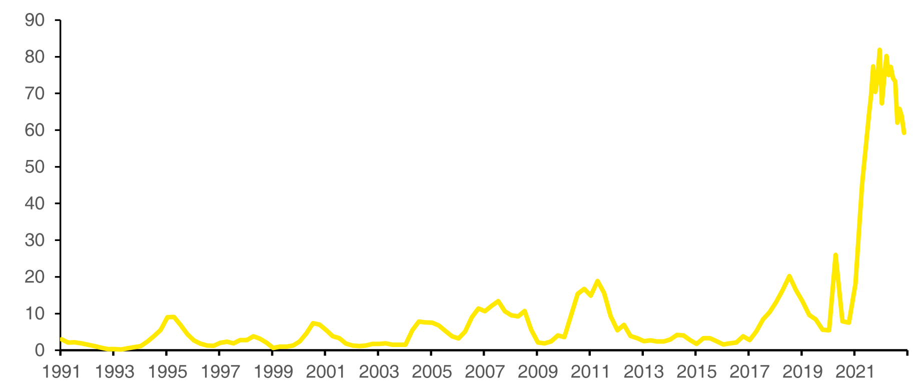


Source: Ifo, Commerzbank Research

- Second, our **gas monitor** signals that Germany is likely to avoid rationing gas in winter. This is supported by fully stocked gas storage facilities, high gas supplies, considerable savings in gas consumption, and the high proportion of gas supplies that do not have to be forwarded to other countries but remain in Germany.
- Third, **supply chain problems have peaked**. Whereas at the peak of the problems around 80% of German industrial companies complained to the Ifo Institute that they were hampered in their production by a lack of upstream products, this proportion has fallen to 59.3% most recently (chart 3). Many companies can now more easily work off backlogged orders, the stock of which is higher than at any time since statistics began in the early 1960s. This stabilizes production, although some of the orders are no longer profitable due to the massive increase in input costs in the meantime.

Chart 3 - Bottlenecks easing

Share of companies indicating in the Ifo survey that a shortage of raw materials/ intermediate goods is hampering their production, in percent, quarterly values.



Source: Ifo, Commerzbank Research

The three arguments speak against a collapse of the economy, but they are unlikely to prevent a recession. For example, the volume of government relief packages in

Germany is huge. But they are not targeted enough to provide complete relief for all consumers and companies. Consumption and investment are still likely to suffer, especially as many European countries have not adopted such extensive packages as Germany. Another argument in favor of a recession is that the Federal Reserve has raised its key interest rate more than at any time since the early 1980s. The European Central Bank (ECB) has also turned the interest rate screw sharply, at least by its standards. Such interest rate turns are weighing on interest-sensitive spending such as construction investment and business investment. The skid marks are already visible, particularly in the US, but construction orders are also falling in Germany.

After the recession in the first half of the year, things should start to look up again in the Western economies. After all, the pain of higher energy prices is slowly fading, and recessions are on average short anyway. As a result, 2023 is likely to be a two-part economic year – recession in the first half, recovery in the second half, although the latter is likely to be moderate as – unlike after previous recessions - the boost from falling key interest rates is missing.

For the average of the coming year, we now expect real GDP in Germany to decline by 0.5%. We have revised our previous forecast of -1.5% from the end of September upwards because since then the probability of a gas shortage has fallen significantly in recent weeks and the German government's aid package has turned out to be larger than expected. For the euro zone, we are raising our 2023 forecast from -0.7% to 0.0%. For the US, we expect stagnation on average for the year (forecast 0.0%, previously: -0.5%); this forecast implies a contraction of the US economy, i.e. a recession, in the first three quarters of next year.

The pattern of a weaker first half of 2023 and a stronger second half also applies to China, even if for other reasons. Because the government is not expected to gradually ease its rigid zero-corona policy until after the National People's Congress in the spring of next year, the economy is likely to suffer from the restrictions for the time being and not recover until the second half of the year. This pattern is also supported by the fact that the crisis on the Chinese real estate market will gradually subside over the course of the year due to government aid.

... also on financial markets

For the coming year, we also expect some easing on the financial markets. Finally, the absence of an economic collapse and a decline in inflation should confirm the world view of many investors:

- ***Bonds:*** Since the beginning of the year, the yield on ten-year Bunds has risen by more than 200 basis points. This makes 2022 a historically bad year for bonds. Yields are likely to rise further in the first few months of the new year because the recession is likely to become mild and inflation to turn out higher than the markets expect. However, if the Fed and ECB respond to the fall in inflation in the spring by ending the cycle of interest rate hikes, bond yields are likely to fall again (year-end forecast for ten-year Bunds: 1.7%). This applies in particular to corporate bonds.

- ***EUR-USD:*** The EUR-USD exchange rate slipped below parity at times due to fears of an energy crisis, which would have hit the euro area in particular rather than the self-sufficient USA. As the risk of gas rationing has meanwhile decreased, EUR-USD was able to recover. This recovery is likely to continue over the course of the year as the markets look more and more through the recession. However, the euro's recovery potential is limited by the ECB's continued deference to countries like Italy (forecast for year-end 2023: 1.10)

- ***Equities:*** Equities have recovered significantly since September, mainly due to the prospect of inflation rates falling again. Nonetheless, equity markets are likely to remain nervous in the first quarter - mainly because of disappointing corporate earnings, which are likely to suffer from rising interest rates, high input costs and the recession. However, such periods of stress should be used to add to equity positions. After all, recessions have often been good entry points in the past because of the low valuation of equities.

Will the EU oil embargo cause oil prices to rise?

Carsten Fritsch

Due to the EU oil embargo and the planned price cap on oil from Russia, oil production there is likely to be significantly curtailed. This should cause the price of Brent oil to rise in the coming weeks.

On December 5, the EU oil embargo against Russia becomes effective. According to IEA estimates, the EU was still importing 1.5 million barrels of Russian crude oil per day in October, which corresponded to just under 15% of total EU crude oil imports (Chart 1). These must now be replaced by new suppliers. From February 5, 2023, the oil embargo will also apply to oil products, of which the EU recently still imported 1 million barrels per day from Russia – including 600 thousand barrels of diesel.

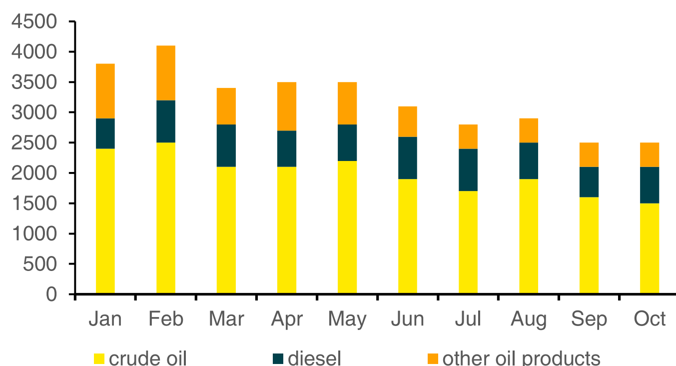
Replacing these supplies is not likely to be easy. For example, OPEC+ has just significantly reduced its oil production, and the increase in US oil production is very sluggish. In addition, the US is unlikely to export significant amounts of diesel to Europe in view of very low domestic inventories.

With a price cap on Russian oil coming into effect at the same time as the oil embargo, oil no longer wanted by the EU is likely to be only partially diverted to other buyers. The cap prohibits European insurers and other service providers from transporting Russian oil to third party countries if the price of the cargo is higher than the cap. This, according to G7 plans, should be in the range of $65-70 per barrel, slightly above the current price of Russian Urals oil (Chart 2). Russia has threatened not to supply oil to countries that participate in the price cap. In addition, Russia could withhold supply if the price of Urals remains well below $70 due to the price cap.

As a result, Russian oil production is expected to decline significantly from December. The IEA assumes that by the end of the first quarter of 2023 around 2 million barrels per day less will be produced than before the invasion of Ukraine. This would be around 1.5 million barrels per day fewer than at present. The supply situation on the market would thus deteriorate significantly, which is why we expect the price of Brent oil to rise back to USD 95 per barrel in the coming weeks.

Chart 1 - High EU oil imports from Russia until recently

In thousand barrels per day



Source: IEA, Commerzbank Research

Chart 2 - Price for Russian oil below planned price cap

Price for Urals oil in USD per barrel, corridor for planned price cap

Source: Bloomberg, Commerzbank Research

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