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Investment Insights | Invesco Fixed Income

Global debt 2023 regional outlook

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Overview

- We believe many of the headwinds that buffeted international risk assets in 2022 are shifting to tailwinds in 2023.
- We expect stabilizing global interest rates over the next few months to provide a high level of nominal income and less volatility in 2023.
- We believe varying regional growth and inflation dynamics could present significant opportunities to seek excess returns through active management.

With global rates nearing a peak, 2023's investment environment is shaping up to be much more constructive than last year's. We expect global rates to stabilize over the next few months, providing both a high level of nominal income and less overall volatility in 2023. With the US Federal Reserve's ("Fed") hiking cycle anticipated to wind down over the next several months and China rapidly reopening, US dollar strength seems to have reached an inflection point. While some uncertainties remain, many of the headwinds of 2022 are shifting to tailwinds for international risk assets. Inflation and growth dynamics vary greatly across regions and countries, which we expect to lead to greater dispersion in individual country returns going forward, presenting significant opportunities for active management.

The Global Debt Team takes a macro-oriented approach to global fixed income markets, investing across interest rates, currencies, and, for some strategies, credit, with an investment horizon of nine to 18 months. Below are the investment dynamics we are watching across major regions.

Developed markets

We believe central banks, particularly the Fed, will continue to be the driving force behind markets in 2023. Having hiked very rapidly and aggressively over the past year – at the fastest pace in 40 years – we expect most, if not all, major developed market (DM) central banks to pause and allow the monetary policy already delivered to impact growth and financial conditions. While additional hikes in the second half of 2023 are possible if inflation does not drop sufficiently, that is currently a risk rather than our base case.

In 2023, we expect market opportunities in DM interest rates to be more about the shape of yield curves, especially in the US and Europe, where the curves have become sharply inverted, and in Japan where the curve remains very steep. Other DM central banks are likely to follow well prescribed paths, with the Bank of Canada expected to finish its hiking cycle in the first quarter and the Reserve Bank of Australia likely to continue its long but cautious hiking cycle.

US

We believe the Fed is approaching the end of its hiking cycle after leading the charge to higher rates across DM central banks over the past year. The Fed hiked rates by 400 basis points in 2022, exceeding prior year expectations that it would deliver 50 to 100 basis points of hikes at most, with current expectations for an additional 50 basis points of hikes in 2023.[1]

Despite the Fed's consistent warnings that the primary risk is not keeping monetary conditions tight enough for long enough, market pricing and the narrative in financial markets have been far more focused on the end of the tightening cycle and an early reversal of policy, including anticipating rate cuts in the second half of 2023. This backdrop suggests that the heavy lifting of tightening financial conditions through higher rates in the US and global market is behind us, as is the persistent US dollar strength.

1. Source: Bloomberg. Data as of Jan. 24, 2022.

We maintain our base case that the US economy remains resilient in the face of tight financial conditions. We expect the consumer to remain buoyant and the fiscal backdrop to be supportive, with increased social security and state and local government spending. While we expect the labor market to become less tight as the economy slows, the remaining shortfall of some four million workers due to retirement and lack of immigration should limit job losses and provide support to underlying economic growth.[2] The primary risk we see to the economic outlook is a rapid decline in goods inflation but not services inflation – keeping the Fed on hold while real rates rise sharply, which could create significant economic headwinds.

While peak Fed hawkishness and declining differentials with other DM central banks should create monetary conditions for the US dollar to continue to ease in 2023, we do see some tail risks. In particular, if US real rates rise sharply due to a decline in inflation with no rapid or adequate response from the Fed, the US dollar could rise, especially vis-à-vis DM currencies.

Given emerging market (EM) central banks' relative monetary policy stance versus DMs, we do not expect EM currencies to underperform their DM counterparts under most conditions. It is worth noting that over the past six years, EM currencies have performed well when compared to DM currencies such as the euro, yen, and currencies of smaller open economies like Sweden and Australia. We expect this trend to continue.

Europe

While we expect most major DM central banks to complete their monetary tightening cycles in the first half of this year, we expect the leadership to shift from the Fed to the European Central Bank (ECB) in the early part of 2023. Facing very high headline inflation, mainly due to energy prices, the ECB has become concerned that these price increases will feed into wages, spurring greater hawkishness in recent months. While our base case is that the ECB will hike into a weak economic outlook, the risks are skewed to higher than expected growth, which would potentially enable it to deliver the additional 100 basis points of hikes that markets have priced in for 2023, while simultaneously delivering quantitative tightening.

We do not expect any major challenges to euro unity in the coming year, even given the possibility that the Russia/Ukraine conflict could become more entrenched and last longer. That said, we do see a risk that Italian fiscal issues could lead to market volatility and a significant widening of Italy's government bond spread to Germany.

Japan

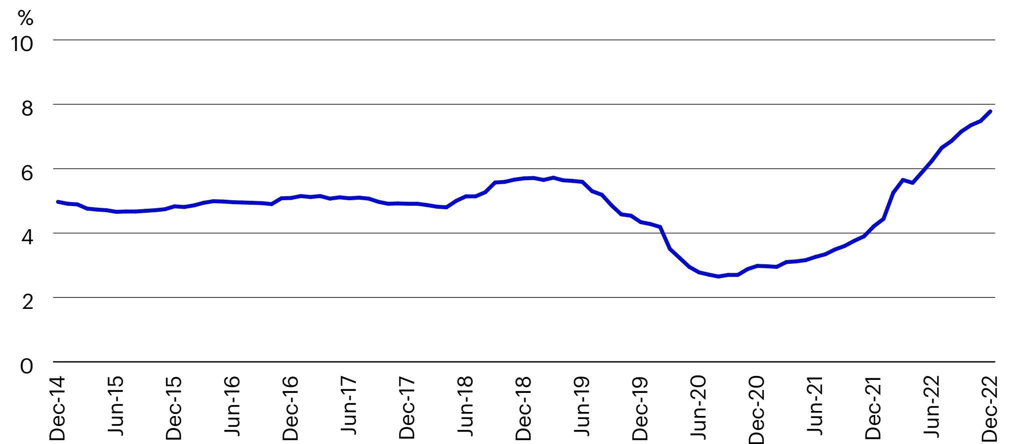
The Bank of Japan's (BOJ) shock change to the yield curve control targets in December opened the path to further changes to BOJ policy in 2023. While we do not expect major shifts, with Governor Kuroda's term expiring in April, the risks are now firmly on the side of further tweaks, or the possible abandonment of Yield Curve Control in 2023. Given that Japanese investors are some of the largest holders of long-term US, European and Australian debt, the implications of such policy shifts will likely be globally significant–potentially leading to higher long-term rates across DMs.

2. Source: Federal Reserve Chair Jerome Powell press conference. Dec. 14, 2022.

Emerging markets

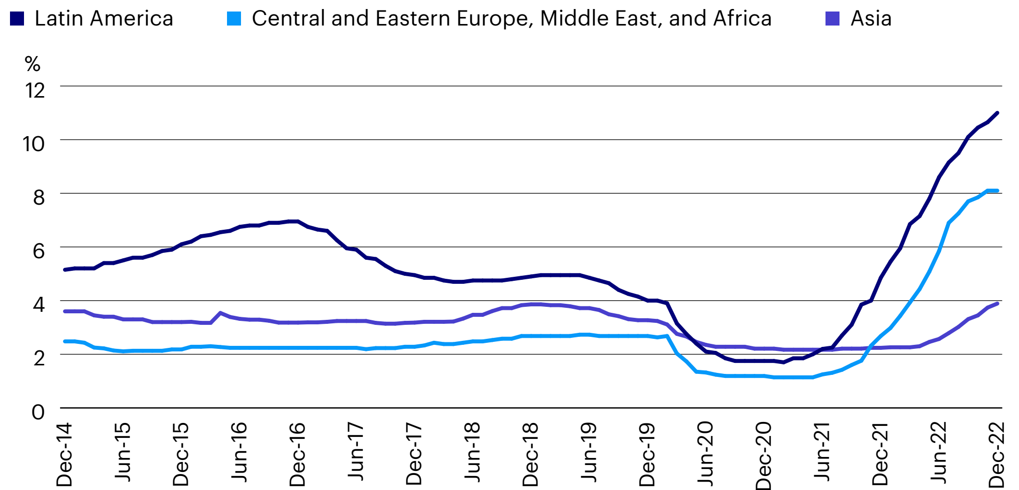
Throughout 2022, EM central banks maintained a focus on fighting inflation, driving the average policy rate from 4.2% to 7.8% — around a 360 basis point rise.[3] Since its low in August 2020, the average policy rate is now more than 500 basis points higher, with stark regional differences: in Latin America and Central and Eastern Europe, Middle East, and Africa, the average policy rate increased by approximately 600 basis points in 2022, while it rose by less than 200 basis points in Asia. In this environment of higher rates and different inflation inflection points, we expect regional and country-specific dynamics to dominate the opportunity set in 2023, versus the large beta moves we saw in 2022.

Figure 1: Average EM central bank policy rate



Source: Bloomberg L.P. Data from Dec. 31, 2014 to Dec. 31, 2022.

Figure 2: Average EM central bank policy rate by region



Source: Bloomberg L.P. Data from Dec. 31, 2014 to Dec. 31, 2022.

3. Source: Invesco. Data from Jan. 1, 2022 to Dec. 31, 2022.

Asia

The shift in China's Zero-COVID policy at the end of 2022 has implications for global growth and EMs specifically in 2023. As the only major economy poised for growth acceleration this year, China's reopening path creates an interesting contrast to growth expectations in DMs, where we expect a slowdown to below 1% in the US and potentially a shallow contraction in the European Union. Even though first quarter activity in China may be weak as herd immunity is built, we expect growth to exceed the current consensus of around 5% for the year, with second quarter growth potentially reaching double digits. We saw strong growth following reopening across the rest of the world in 2022 and considering that China has been in lockdown for longer than most countries, we expect a significant pick-up in activity.

We expect the impact of China's reopening on EMs to be twofold: First, we expect China's incremental commodity demand to increase starting in Q2, especially for energy but more broadly for all commodities, as infrastructure projects ramp up. This should benefit the currencies of EM commodity exporters, such as the Chilean peso, the South African Rand, and the Indonesian rupiah. Second, we anticipate a tourism boost across the region, starting in the summer, with countries like Thailand and South Korea likely to enjoy strong demand in 2023. We also expect reopening to catalyze a short-term inflationary impulse in the region from both goods and services. Nevertheless, given China's low inflation levels, we are not concerned about runaway inflation.

Beyond China, we can group countries in Asia into three categories in terms of monetary policy: ahead of the curve, catching up, or in wait-and-see mode. South Korea and Singapore are both ahead of the curve, with South Korea being the first hiker in the region. As a result, the Korean won, is likely to benefit the most from this monetary policy stance, as well as from China's reopening. India, Indonesia, and the Philippines were slow to start their hiking cycles but have been catching up quickly and could be nearing the end in the next few months. In contrast, Thailand and Malaysia have been slower to act and have taken a more wait-and-see approach – they may be close to the end, but we could see further hikes, depending on the speed and impact of China's reopening.

Latin America

Latin American countries were the first to begin their hiking cycles as inflation began to pick up early in 2022. Additionally, these economies outperformed on the growth side for most of the year. We believe this trend of higher inflation and higher growth has likely peaked, and these economies should have an opportunity toward the end of 2023 to cut policy rates and exit restrictive territory. We do not expect the region as a whole to go through a recession, as commodity exports to China will likely provide a boost to growth. Instead, navigating political headlines will likely be important for investors in 2023. We returned from our trip in November with the impression that the situation was more positive than offshore investors had feared in Colombia, that change would be gradual in Chile, and that the impeachment process could bring about a positive outcome for Peru. While we still believe this is true, headlines like the ones that have dominated the first few weeks of Brazilian President Lula's third term in office will need to be watched carefully for signs of positive reform agendas or a reversion to populist spending. Overall, our outlook is bright for Latin America in 2023, as significant value was created in 2022.

Central and Eastern Europe, Middle East and Africa (CEEMEA)

Despite the region's proximity to the Russia-Ukraine war, its growth story was surprisingly robust in 2022, though inflation remained sticky. We expect inflation to peak in CEEMEA later than in other regions (where inflation is generally rolling over), yet the Central and Eastern European central banks have been on hold for the last few months (except Romania, which has simply slowed its pace). While some data from Poland supports their anticipation of a pending decline in inflation (albeit assisted by subsidies), we would not be surprised to see some persistence of higher-than-expected broad-based inflation in the region (i.e., more than just initial supply-side pressures), that could force some central banks to re-engage in hikes. The potential for resuming rate hikes increases if a hawkish ECB results in more pressure on their respective currencies. Regardless, we expect the region to see more persistent inflation than other regions. South Africa may be the exception where, absent more political drama, inflation may decline significantly in the second half of the year, which could open a window to cut rates late in 2023.

Conclusion

While central bank overtightening could cause sluggish global growth, the exact speed of China's reopening is uncertain, and geopolitical risks remain, we believe the main indicator to watch is how fast EM inflation declines. We expect a meaningful improvement toward central banks' targets in the first half of this year, which could open the door to some rate cuts in a few countries. That said, if inflation does not fall to countries' respective target ranges by the end of 2023, a sizeable rate cutting cycle would seem unlikely. Importantly, we expect varying regional growth and inflation dynamics to lead to considerable dispersion in country returns, which we believe presents significant opportunities to seek excess returns through skilled active management.

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