2023 Year Outlook

The Secret Economist

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2023 **Winter is** coming

Welcome to **The Secret Economist's 2023 outlook**, powered by Moneycorp. In this edition, The secret Economist gives their views on the shape of the economy for the year ahead, and what major events are likely to impact monetary policy.

2022 was meant to be the year when the global economy, supported by a widespread rollout of COVID-19 vaccines, pushed on and enjoyed an additional healthy rebound. However, even towards the end of 2021, the concerns over the pace of economic expansion intensified as growth forecasts started being revised lower. The first few months of 2022 didn't reveal much by way of additional concerns from a growth perspective. Still, significant geopolitical changes, ongoing supply-side problems for much of the year, and widespread labour market supply constraints meant 2022 didn't look anything like it was expected to.

As we closed out 2022, momentum had been lost across the vast majority of major economies. And at the start of 2023, it was shaping up to be a very poor year in terms of growth and one still beset by above-trend inflation issues, though a significant reduction in inflation rates was expected by the end of 2023. Inflation should be close to target by the end of 2024 (if not below).

I warned in the 2022 outlook that central banks would need to carefully consider the appropriate action regarding the contrast between growth and inflation. For seven months of 2022, it appeared the central banks were following this approach. However, any attempts to insulate economies were abandoned in August, in favour of more aggressive monetary tightening, mainly through conventional interest rate hikes, but lately, the reversal of quantitative easing policies as well.

2023 may well be a year of recessions and reconsiderations; recessions in the major economies and reconsiderations from the likes of the Bank of England, Federal Reserve, and European Central Bank about the appropriateness of monetary policy. There will also be pressure on fiscal authorities, with the prospect of recessions prompting a worsening in receipts and a rise in cyclical spending, as well as increasing the possibility of fiscal stimulus to support recovery.

The risks are that US, UK, and European interest rates, having peaked in early 2023, will have to be cut earlier than anticipated, even while the inflation rates remain above target. The peak for US rates is likely to be around 5.5%, for UK rates 4%, and the Euro Area around 3% (refi). Any assumption that 2023 will be a year of less volatility for financial markets may well be immediately tested.

Figures quoted from Bloomberg

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2023 GDP

A reverse beauty parade as all economies suffer

Global growth for 2022 is set to come in at about 3%. That is half the growth seen in 2021 and a third less than the expected outturn at the start of 2022.

2022 will be remembered for the short-lived US recession in the year's first half and the sharp and sudden loss of momentum in UK economic activity in the second half of the year. The major geopolitical disruption of Russia's invasion of Ukraine and, in particular, its effect on supplies of natural gas and key agricultural commodities.

Supply chain disruption also lasted throughout the first half of 2022, with zero COVID policies from China, container shortages, and freight costs all playing a part in hurting potential growth. The aggressive nature of monetary tightening from most central banks throughout 2022, particularly in H2 from the major central banks of the US, Euro Area, and the UK, has prompted the latest downward revisions to growth expectations in 2023 and beyond.

In the 2022 outlook, I suggested that growth would be slower in 2022 and 2023 but not as slow as is now expected, with the biggest obvious difference being where I expected interest rates to be.

Table 1: Global economic growth (%)

	2022	2023	2024
World	3.0	1.8	2.2
US	1.4	-0.3	0.9
Euro Area	3.3	0.0	1.4
UK	3.1	-1.5	0.3
Japan	1.6	1.8	1.5
China	3.0	3.7	3.9
India	6.5	5.5	6.4
Canada	3.3	1.2	2.5
Australia	3.6	1.7	2.1
New Zealand	2.1	1.6	2.3
Brazil	2.6	1.2	2.2

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Are there any upside opportunities or risks to growth, investment, and spending?

The short answer to this question is no, at least not with where current global monetary and fiscal policies are. So, the question is, which of the economies will perform the least badly over the course of 2023?

The UK

Bank of England's sacrifice play won't pay off.

The UK economy was expected to grow by around 3.5% in 2022, but it looks as if the outturn will be closer to 3% when the Q4 numbers come in. A number of factors have caused the deterioration in economic activity.

The Russian invasion of Ukraine has sharply increased the cost of living, with the prices of necessities & staples up around 20% year on year and the UK government having to step in to limit the price increases in energy bills. That has hit hard as far as discretionary spending is concerned, with major retailers and hospitality feeling the most significant pain.

Higher inflation has prompted higher interest rates from the Bank of England, with interest rates set to close out the year at 3.5%, beginning at just 0.25%. The rapid increase in interest rates has sharply reduced demand for UK property while at the same time forcing up rent charges. This has created a perfect storm to undermine the UK housing market, which has seen some of the sharpest declines in property prices since the financial crisis.

The tightness of the UK labour market and the increased cost of living has prompted widespread strike action as workers seek higher wages to compensate for the rise in necessary goods and services. However, that strike action, including across the public transport network, has added an element of negativity to UK activity.

Political uncertainty has also played its part, with three Prime Ministers in five months, and as many Chancellors, a mini-Budget, several U-turns, and plenty of rebellions offering the economy a less than a stable political platform. The damage from the mini-Budget, in terms of the surge in market interest rates, was the most unhelpful part of the political uncertainty.

Finally, the passing of Queen Elizabeth II late into Q3 prompted a sudden loss of momentum that didn't recover in early Q4 as the cumulative effect of interest rate increases and the surge in borrowing costs took over quickly after that.

At the end of 2022, a recession appeared to be underway, with the UK housing market in full retreat, retail sales volumes down sharply for seven of the first ten months of 2022, and manufacturing and services activity surveys pointing to ongoing contraction.

What does 2023 hold for the UK?

The challenges for the UK economy at the start of 2023 are sizeable and revolve around the cumulative increase in borrowing costs, ongoing labour market disruption through strike action, a higher taxation environment, and an additional squeeze on discretionary spending from another wave of food price inflation and the risks of another surge in energy prices. One counterbalancing factor is the prospect of lower freight costs as global demand continues to slow.

The threat of higher interest rates should fade in the early stages of Q2 '23, and even though the UK consumer price inflation rate will remain well above the 2% target level for the whole of 2023, only falling sharply in H2 '23 (still likely to end 2023 around 5%). The medium-term risks are for a prolonged period of sub-target domestically generated inflation in the UK, driven by a sharper recession than authorities expect.

The global economy continues to suffer from supply-chain issues around geopolitical risks (Ukraine-Russia war) and the Chinese zero COVID policy. For most economies, that could mean stickier inflation in the short term, but UK businesses will struggle in high inflation and a higher interest rate environment. This is likely to undermine investment spending and could arrest the recent strength of the UK labour market. However, the labour market issues are multi-faceted, with low levels of domestically generated labour supply and a more significant challenge in immigration in a post-COVID, post-Brexit world. The weakness of labour supply could undermine growth and boost inflation, providing the Bank of England with an even greater headache into 2023 than it had in 2022.

The UK's fiscal position is equally problematic regarding what it will mean for growth. More tax heaped on households and businesses is likely to lead to slower or negative economic activity. The risks to GDP in 2023 are to the downside, with the UK recession potentially being greater than a 1.0–1.5% off growth expected. The UK government may have to reconsider its strategy regarding tax increases, but that will likely be next Autumn at the earliest before it changes. The pressure on the economy from higher energy prices could also cause greater damage. The UK authority's sacrifice play, sacrificing the UK economy for control of inflation, assumes that inflation can be brought back to target and held there, whereas that might not be possible. 2023 looks to be increasingly challenging for the UK authorities, who are largely culpable for the extent of the problems the UK will experience.

Figures quoted from Bloomberg

The US

Danger signs flashing everywhere

In 2022, the US suffered a short technical recession in the first half of the year, and though activity has bounced back, the risks of recession in 2023 have been steadily increasing. That is despite the labour market, which has printed an additional solid rebound in net employment, although recently, the key employment sectors have recorded a sharp increase in layoffs. Furthermore, the relative strength of employment has not been reflected in higher real wages, with consumer price inflation comfortably outstripping average earnings growth throughout 2022.

The US economy was set to close out 2022 having grown by around 1.4%, the slowest growth of all the major economies. GDP is set to drop sharply in 2023, with a recession of 0.7% predicted in the first 2-3 quarters of the year. Consumer confidence has been weak, the US housing market is now in a deep recession, with home sales having already fallen by more than a fifth, and the retail sector has seen a significant drop in discretionary spending. There is little or no momentum to carry into 2023, and the cumulative effects of monetary tightening are set to bite deeper in 2023.

The Federal Reserve, concerned by a persistently significant overshoot in inflation seen in the first half of 2022, has increased the Fed Funds rate from a record low of 0.25% (as recently as February 2022) to 4.5% at the end of 2022. Rates are set to peak above 5% in 2023 despite weakening activity. The problem for the Federal Reserve is that many of the issues creating the inflation are supply-side rather than demand-side, driven. Therefore, interest rates are much less effective in controlling inflation since the Fed is in much less control of the supply-side factors, and only crashing the economy would produce a sufficiently sharp reduction in demand to match the supply-side disruption.

The US's recovery is at risk of being sacrificed to bring inflation back under control. Still, the symptoms do not merit putting the US consumer and businesses into a prolonged coma. The Federal Reserve spent much of the early part of 2022 suggesting there was no recession, stating that it remained in its gift to bring about a soft landing while bringing inflation back under control. The Fed has abandoned efforts to achieve the soft landing, and the US economy risks a crash landing instead. Those at the controls of the US economy risk being blamed for a longer and deeper recession, and a much slower recovery 2023 and beyond.

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The Euro Area

Stagnation is the best the ECB can hope for

Table 2: Consumer price inflation (%)

	2022	2023	2024
World	8.8	5.9	3.7
US	7.8	3.7	1.9
Euro Area	8.4	5.4	2.3
UK	9.4	7.7	2.9
Japan	2.1	1.7	1.1
China	2.2	2.2	1.8
India	6.9	5.0	4.0
Canada	6.8	4.0	2.1
Australia	6.4	4.4	2.3
New Zealand	6.3	3.5	2.2
Brazil	9.6	4.8	3.3

As 2022 draws to a close, the Euro Area's momentum is pointing towards stagnation in 2023, with most surveys indicating recessionary conditions in manufacturing and services and confidence amongst consumers and businesses close to record lows. The signs have been particularly troubling in Germany, where the pressure from energy prices and supply disruption has left the economy dragging on the rest of the Euro Area. However, for the first three quarters of 2022, the European economy has performed the best of all the major economies. The loss of momentum has only occurred as the rate increases from the European Central Bank stepped up in Q3 and Q4 of 2022.

The negative economic prospect of further COVID lockdowns for the Euro economy has receded but has been replaced with aggressive monetary tightening and ongoing supply-side disruption. After Russia's invasion of Ukraine in February, war on the border of Europe remains the largest single threat to Europe, both militarily and economically.

Inflation has recently dipped in the Euro Area, but not before the rate exceeded 10.5%. Core inflation is also running at 5% y/y, 2.5 times the target rate of 2%. So, there is still work to be done to bring down the rate of inflation, especially as the wage round for 2023 is likely to kick off with higher wage demands from across industry and service sectors, and 2022 was beset with strike action in France and some other major economies.

The best the European Central Bank can hope for in 2023 is stagnation, but the risk is for a short-lived recession. European interest rates haven't risen to anywhere close to the UK or US levels, which is perhaps one supportive factor. The fiscal authorities are generally more accommodative from a policy perspective than counterparts in other economies. Finally, the euro's weakness against the US dollar could prove helpful regarding net trade growth in the back end of 2023. However, the global loss of economic momentum is a massive threat to the major economies, and the energy crisis is far from over. The theater of war for Russia could be expanded after numerous threats from Russian Premier Vladimir Putin. There is also the prospect of persistent planned quantitative tightening from the central bank throughout 2023. So even if the European Central Bank eases off on the conventional monetary tightening (interest rates), there will be significant headwinds to activity throughout 2023.

Growth will likely be flat for 2023, although markets should not rule out the prospect of a short-lived, shallow recession in the first few quarters. 2024 looks like it will be a better year, but growth will likely fall short of trend rates of expansion and just short of 1.5% for the whole year.

The European Central Bank should be able to relax the pace of interest rate hikes in early 2023 and potentially cut the cost of borrowing before the year is ought, as it becomes increasingly obvious that inflation is set to slump.

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Rest of the World

Different challenges greet Asia and emerging markets

If we look firstly at China, the problems for growth have been almost solely prompted by zero-COVID policies that have disrupted the supply chain and set the domestic economy an insurmountable challenge. In particular, repeated shutdowns of businesses, the surge in commodity and energy prices, and a global economic slowdown have left the economy falling far short of the 5% growth expected. Instead, 2022 should see the Chinese economy grow by only 3% expected, with protests at COVID restrictions creating even more problems for Chinese authorities. For 2023, there should be a slow relaxation of COVID policies, but the key issue for China is the lack of widespread immunity that could prompt renewed healthcare challenges. China hasn't experienced significant inflation so hasn't had to hike interest rates to deal with it, but will nonetheless suffer a slowdown in activity from global monetary tightening.

China's problems from the corporate sector are also far from resolved. In 2021 it was Evergreen that caused the greatest alarm, while in 2022, Chinese authorities acted to try and reduce the influence of major Chinese tech businesses. This, along with the protests and economic slowdown, has overshadowed the historic third term of Xi Jinping as Chinese Premier, who will find it challenging to restimulate activity without increasing the Chinese economy's risks of over-leverage from all areas (government, corporate, and household). It appears unlikely that the People's Bank of China will continue to cut banks' reserve requirement ratios in the face of weakening fundamentals and credit quality.

The other major Asian powerhouse for recovery, India, has enjoyed much better fortunes in 2022, albeit the economic growth observed has also been somewhat below what was expected. 2022 is expected to record growth of 6.5%, well short of the anticipated 9.5%+, and 2023 is likely to see growth of only 5.5%. Again, the Indian economy is likely to suffer from a sharp reduction in global economic activity and the hikes already implemented by the Reserve Bank of India. Since early April 2022, Indian interest rates have risen from 4% to 6.25%. That will take the momentum out of the Indian economy in 2023, with further rate hikes expected in early 2023 and any later cuts unlikely to reverse the damage done until the end of 2024.

Australia and New Zealand have endured a slowing in the pace of growth in 2022. Australian growth is expected to be 3.6% when the Q4 figures are released, whereas the New Zealand economy is set to grow by just over 2.1%. Both economies are growing more slowly than anticipated, and a lot of that has to do with the rate increases from the Reserve Bank of Australia and the Reserve Bank of New Zealand. The RBA hiked interest rates from 0.1% to 3.1% over 8 months, and the RBNZ hiked from 0.75% to 4.25% in 2022, from a 0.25% low in September 2021. 2023 is likely to see interest rates rise further in Australia to around 3.6% and New Zealand to 5%, but neither central bank is expected to leave interest rates there for very long. Growth is expected to be sluggish in 2023 for both economies, well under trend and with downside risks attached. Australian growth is forecast to be 1.7%, while New Zealand is set to grow slightly more slowly at 1.6%. Inflation in both countries is set to fall sharply, with the latent effects of higher energy costs and the surge in commodities unwinding in 2023. Within two years, inflation should be back on target. That will give the RBA and RBNZ room for rate cuts in H2 '23.

Canada's economic recovery has been somewhat affected by the weakness in the US economy in the first half of 2022, but growth still looks set to be around 3.3% for the whole year. This, again, is weaker than what was expected towards the back end of 2021, when the Canadian economy was predicted to grow by around 4.75%. The weakness of the Canadian economy observed in the second half of 2022 was driven by rising borrowing costs from the Bank of Canada. Still, there were also residual issues regarding the surge in inflation for necessity goods and the slowdown of the Canadian housing market. The Canadian labour market has remained strong, but beyond the headline figures for employment growth, there have been more troubling numbers regarding the employment ratio and signs of increasing layoffs.

2023 is likely to see the Canadian economy slow further, with interest rates expected to continue to climb in the early part of the year and growth forecast to slow to only a trace above 1%. Inflation is expected to fall sharply in 2023, dropping from 6.8% to 4%, returning close to the target within two years. However, with the risks to the domestic economy's downside and widespread global economic issues, the Bank of Canada may be compelled to reduce interest rates well ahead of inflation dropping back below target.

For the developing world, 2022 has been a year of significant monetary tightening in Central and Latin America and Eastern Europe, as inflation overshoots and currency weakness have dominated growth. It is remarkable how quickly fears over inflation have replaced fears over the pandemic, and the central banks have been swift and aggressive in conventional monetary policy tightening. Nowhere is that more evident than in Brazil. **The Brazilian** economy has struggled for growth this year and is set to close out the year with a lacklustre 2.6% growth, significantly lower than the 5% predicted at the end of 2021. The Selic rate is set to end 2022 at 13.75%, after starting the year at 9.25%, which was up from a low of 2% in March 2021 since the onset of the pandemic. That was the single largest reason for the poor performance of the Brazilian economy, irrespective of political problems, COVID-related healthcare issues, and the global slowdown. Brazil is set for an even worse outcome in economic growth in 2023, with growth forecast at just 1.2%, based on Brazilian interest rates rising no further. Overall, whether it is Latin America or any other emerging market region, the risks on GDP for 2023 are for slow or negligible growth unless there is a seismic shift in monetary policy.

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Monetary policy

Can any central bank claim it's really working?

2022 was the year when reality bit. The problem for major central banks was that the cause of inflation wasn't rooted in only its domestic economy, but rather that the inflation was a hangover of COVID and was then freshly stimulated by geopolitical problems.

COVID continues to prompt supply-chain issues. The labour market is a key area where supply has been in a greater shortage than expected, despite high inflation that ought to encourage healthier job seeking. Health is a key element of this, with COVID having created a number of long-term health issues and healthcare centres dealing with a growing backload of cases.

Hot on the heels of the supply-chain disruption was the Russian invasion of Ukraine in February. There was already a sharp rise underway regarding energy prices as Russian troops built up on Ukraine's border. Still, the invasion itself, the West's response in terms of sanctions, and Russia's counter-response pushed gas prices to many multi-times previous highs, and oil prices surged to close to $140 per barrel. It was this surge in energy that so spooked monetary authorities in the West.

So, the inflation being seen can't be solved by individual monetary tightening since it is supply-led rather than demand-driven, but a collective demand shock might do the trick. That appears to have been what was tried in 2022, with the main central banks joining late to this party.

Higher interest rates got momentum from all of the major Western central banks in Q2/Q3 2022, and the scale of the rate increases was enormous versus where interest rates had been for the best part of the past 13-14 years. With US interest rates set to close out the year at 4.5%, UK interest rates at 3.5%, and Euro Area rates at 2.5%, indeed, the vast majority of the leg work has been done to break the back of the inflation surge, even if it hasn't emerged yet?

Well, it is more complex than that, with the central banks a lot less trustworthy of their own inflation projections than they were and likely to overcook the extent of the tightening, much like they had done with loosening monetary policy amid the pandemic.

Supply chains will still be difficult for much, if not all, of 2023, although freight costs are likely to further reduce based on lower global activity rates. Labour market supply issues are likely to ease in the short term, but the longer-term headwinds on labour supply remain across a broad number of sectors, and that could boost wage demands for years to come, especially if investment spending remains prohibitive in terms of the interest rate hurdle it is required to surmount.

The biggest reason to think that interest rates will come down in 2023 boils down to activity. No central bank will be willing to permit a prolonged period of recession, and there is plenty of history to back this argument up. Look at the period of the Great Depression of the 1930s and the actions of the Fed, for example. The risks to inflation are also to the downside for the end of most central banks' forecast horizon, so rates might, and probably ought to fall next year.

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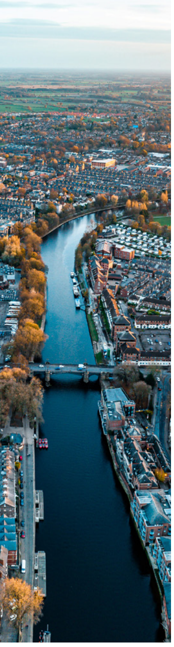
So what will happen in 2023 regarding monetary policy?

Starting with the United States, the Federal Reserve is likely to hike rates to a peak of 5.25-5.5%. There is some risk of a marginally lower peak, especially as the Fed is set to continue with its quantitative tightening throughout 2023.

Momentum in the US economy has ebbed away, particularly in retail sales, the housing market, and even later in industry as well. That loss of momentum will prove difficult to rediscover, with a strong labour market a critical factor in any economic expansion but insufficient to bring about further US economic prosperity.

By the middle of 2023, growth will likely be in negative territory as the cumulative weight of interest rate tightening weighs heavily on business investment and consumer spending. By the time 2023 comes to a close, interest rates in the US could be back at 3.5%, with a further fall in 2024 as inflation risks remain for a prolonged dip beneath the 2% target. Here's the kicker as well, the US central bank, wracked by indecision in 2021, overstimulated demand and then, in 2022 realising its mistake, was overly aggressive in monetary tightening. Does 2023 mean that the pendulum swings back in the other direction as the Fed fumbles to find the right formula?



In the UK, the Bank of England is expected to raise interest rates to 4.5% by the end of Q1 2023. However, there is a significant risk of a much lower peak as higher borrowing costs and still elevated necessity goods and services prices eat away at net disposable income. The upward pressure on UK inflation rates might recede, but the stickiness of inflation might be more pronounced due to a lack of productivity growth and business investment spending, as well as ongoing strike action from unions. That means that the speed at which interest rates fall will likely be slower than in the US if it manifests at all in 2023.

There is a strong argument regarding the need for interest rate cuts from the weakness in economic activity, the collapse in the housing market, and the signs of pronounced pressure on real disposable incomes. However, the Bank of England would counterbalance that with signals of rising domestically generated inflation pressure and weakness in the pound that is importing more inflation from overseas.

UK interest rates have done the bulk of the heavy lifting as far as monetary tightening is concerned. However, with quantitative tightening (QT) expected throughout 2023 and fiscal policy being tighter than predicted, the conventional levers of policy tightening might be relaxed a little. If that happens, it will be towards the end of 2023.

With the risks of a persistently large undershoot in consumer price inflation rising between two and three years in the BoE's own forecast, there will come a point when the central bank either admits its forecasts are subject to much greater uncertainty or recognises the need for a significant reduction in interest rates. The current tactic of significant rate hikes from the Bank of England risks turning a downturn into a slump.

As for the European Central Bank, 2022 has seen the economy outperform other majors, but the recent loss of momentum is troubling. Interest rates have moved from 0 to 2.5%, with inflation overshooting the target rate considerably, albeit mainly because of energy price rises and the effect of higher energy prices on food and other necessity goods' prices.

The European Central Bank was the last of the major central banks to instigate monetary tightening but now appears to be playing catch up. European interest rates will close out the year at 2.5% and are expected to rise to a high of 3.25-3.5% in 2023, probably before the end of Q1. Overall, the economic situation in Euroland isn't as bad as what we're seeing in the UK, or what is likely to happen in the US. There may be some closing of the interest rate gap, as the ECB is unlikely to reduce interest rates as quickly as the BoE or Fed.

Furthermore, the ECB will still be re-adjusting its balance sheet, continuing the quantitative tightening that began late into 2022 and throughout 2023. As inflation is brought back under some semblance of control in the latter stages of 2023 and into 2024, the ECB may be in a better position to cut interest rates, but 2024 would appear to be a more likely time for those rate reductions.

Figures quoted from Bloomberg
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Rest of the World

Monetary policy in the rest of the world has been tightened even further in 2022. An unhealthy mix of above-target inflation, currency weakness, geopolitical risks, energy price spikes, and supply chain weaknesses have prompted central banks in many regions to raise rates aggressively once again.

Table 3: Key central bank interest rates (%)

	2022	2023	2024
US	4.50	3.50	2.50
Euro Area	2.50	3.00	1.50
UK	3.50	4.25	3.25
Japan	-0.10	0.00	0.00
China	3.65	3.45	4.15
India	6.25	5.45	4.85
Canada	4.25	3.50	2.50
Australia	3.10	2.75	2.25
New Zealand	4.25	4.00	3.50
Brazil	13.75	12.50	9.50

In ***Eastern Europe***, we saw hikes from the central banks of Poland, Hungary, the Czech Republic, and Romania. The National Bank of Poland raised interest rates from 2.25% to 6.75%, the highest Polish rates have been since early 2003. The Czech central bank has raised rates from 4.5% to 7%, a modern record for Czech interest rates, while the Hungarian central bank has increased rates to an all-time high of 13% from 2.9% at the beginning of the year. These astronomic interest rates are undermining growth, along with the surge in energy prices, and are yet to offer much support to the currencies. 2023 should be a much quieter year for interest rates in the region, with cuts likely between the middle and end of the year.

In ***Latin America,*** the central bank of Brazil raised interest rates from 9.25% to 13.75% in 2022, again driven by currency weakness, high inflation, and energy price surges. 2023 is likely to see interest rates peak at around that level and fall back in the year's second half as inflation rates recede. The other big central bank news came from Banxico. The Mexican central bank raised interest rates from 5.5% to almost double that, rates ending the year at 10.5%, but again expected to stay relatively high from there in 2023. Rates could peak around 11.25% in Q1, with cuts coming later into 2023, bringing them back to 10% or even marginally below that level by year-end.

The ***Bank of Canada's*** hiking cycle is almost over, but one more hike might come in 2023. Rates increased rapidly in 2022 and ended the year at 4.25%. For the most part, the Canadian economic recovery has continued unabated. Still, the recent accumulation of interest rate hikes is beginning to take a toll on economic momentum and has already prompted a sharp drop in housing activity. Rates are likely to peak around 4.75% in early '23 and then fall back to 3.5% in the second half of the year.

As for ***Australia and New Zealand,*** the central banks will find themselves in an invidious position at the end of 2022. The economies have not enjoyed the post-COVID bounce hoped for and still have above-target inflation rates. As a result, both currencies have performed poorly for much of the year. Australian interest rates are set to peak at 3.6%, with the Reserve Bank of Australia likely to cut interest rates in Q4 2023 as inflation rates return towards target. On the other hand, the Reserve Bank of New Zealand could see a peak of 4.75% in official interest rates and fewer cuts despite the expected weakening, with inflation and currency weakness potentially a medium-term problem.

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The FX out-look

2023 bigger swings ahead

It is unlikely that many saw the geopolitical events that unfolded in February as the main risk for 2022 when 2021 closed. The invasion of Ukraine by Russia prompted a sharp rally in the dollar that lasted for most of the year before position squaring saw the US dollar giving back a significant portion of its gains. The geopolitical risks spawned energy supply concerns, and those, in turn, were at least in part responsible for the interest rate hikes and the growing cost of living problems for many economies around the globe. The US was seen as insulated from this, but it performed worst in H1 2022 and was unsuccessfully playing catch up in the latter half of the year.

There was a reduction in market confidence and risk appetite, which saw most equity indices down over the year. Still, at one stage, the situation could have been far worse. The recovery in risk appetite and position squaring ahead of the year's end meant that the likes of the pound, euro, and yen closed out the year in a much better place than they had been at the beginning of the fourth quarter.

2023 could be a year of more significant difficulties for the FX markets regarding conflicting signals from most major economies and increasingly complex choices for central banks facing still above-target inflation and below-trend growth. 2022's volatility is not expected to be replicated if you speak with most market participants; however, given the sub-optimal macroeconomic and geopolitical conditions still in operation, sharp swings in currencies should not be ruled out.

Having tested higher towards the back end of 2022, what is in store for EURUSD in 2023? There is room for the euro to recover further, but there are challenges to risk appetite that could re-energise US dollar demand against other majors. If the macroeconomic outlook worsens more materially than expected, then we could head back towards and beneath parity, as happened at the end of Q3 '22. The euro's upside may also be limited by further geopolitical risks, such as expanding the theater of conflict in the current Russia-Ukraine war.

Figures quoted from Bloomberg
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The FX outlook

Table 4: FX forecasts (forecasts are end period and vs USD unless stated)

	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
EUR	1.02	1.00	0.95	1.03	1.06	1.09	1.11	1.12
GBP	1.15	1.12	1.07	1.12	1.16	1.19	1.22	1.25
JPY	142	145	151	140	135	130	128	126
CHF	0.93	0.92	0.91	0.94	0.96	0.98	1.00	1.01
CAD	1.36	1.38	1.41	1.35	1.32	1.30	1.28	1.27
AUD	0.66	0.64	0.63	0.68	0.70	0.72	0.73	0.74
NZD	0.62	0.60	0.60	0.64	0.65	0.67	0.68	0.69
CNY	7.05	7.27	7.45	7.30	7.20	7.10	7.00	6.95
INR	82.60	84.00	84.50	86.70	85.20	83.70	82.10	80.90
BRL	5.35	5.45	5.50	5.55	5.4	5.25	5.05	4.90
GBPEUR	1.13	1.12	1.13	1.09	1.09	1.09	1.10	1.12
EURGBP	0.89	0.89	0.89	0.92	0.92	0.92	0.91	0.90
EURSEK	10.85	11.05	11.25	10.75	10.60	10.20	9.90	9.65
EURNOK	10.50	10.80	10.95	10.55	10.40	9.95	9.80	9.55

For the pound, the headwinds to growth are greater, thanks to tighter monetary and fiscal policy than previously planned. Non-indexation of income tax and national insurance levels will bring more to HM Treasury's coffers but also undermine any recovery in disposable incomes or the macroeconomy. 2023 could be challenging against the US dollar and euro, with the UK economy underperforming against the other major economies. Furthermore, the environment for business investment is expected to remain negative, so attracting foreign capital to fill the gap created by the current account deficit will also be harder. GBPUSD might test down towards last year's lows around $1.0350, while GBPEUR could head back beneath €1.10.

If the Bank of England were to hike more than the markets currently expect, then there could be some upside for the pound against the dollar and euro, but higher interest rates are insufficient for a sustained recovery in the pound. The best bet the pound has to sustain a rally is if things worsen more materially in the US and Euro Area economies. This could occur if the monetary and fiscal policy mix goes wrong for them and if the US housing market recession intensifies. If GBPUSD were to rally, it may struggle to regain the $1.30s throughout 2023. Against the euro, the pound could test €1.20, but there is little to keep it there without an unexpected collapse in the Euro Area economy.

The weakness of the global economy in 2023 could return pressure on other currencies in the developed world and emerging markets.

The recent dip in oil prices seen at the back end of 2022 is driven by lower global demand, which is yet to be met with any reduction in OPEC supply, but in early 2023 OPEC could be forced to take out more capacity from oil production. Even that may not be sufficient to rebalance things, which could put renewed pressure on the likes of the CAD, AUD, and NOK in the first few quarters of the year, reversing the recent gains these currencies have made against the US dollar.

The volatility of the Chinese renminbi in 2022 has been driven by economic weakness, and the increase in unrest in many major cities around China, with protests against the restrictive lockdowns implemented a recurrent theme. The recent rally in the CNY has been associated with the relaxation COVID rules. This is expected to persist throughout 2023 as the economy returns to operational normality. The headwinds to growth are likely to strengthen, with exporters facing recessions in the UK and the US and stagnation in the Euro Area. Even stronger growth than is forecast might not help the CNY, with levels of debt climbing in China and pressurizing financial stability.

2022 saw the Indian rupee underperform again despite the economy looking healthier for much of the year versus other emerging markets. 2023 might be no better, with the Indian economy still growing more than major economies and performing better than China, but that is still insufficient to shore up the rupee. Any prolonged period of economic weakness for the global economy is likely to undermine export growth, and Indian interest rates are equally unlikely to be high enough to offer anything other than temporary support for the rupee. Another 3-5% depreciation against the US dollar is the central scenario to be expected in 2023.

Figures quoted from Bloomberg
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2023 Headlines

Can any central bank claim it's really working?

US and UK economic recessions are likely, the latter being almost inevitable. The cumulative tightening in monetary policy and squeeze on real incomes from high necessity goods and services prices is key to this outcome.

Heightened currency market volatility is likely to remain a feature in 2023 after some large swings in the fortunes of the majors over 2022. The risks are for a reversal of euro and sterling strength seen in Q4 2022 throughout H1 '23. GBPEUR might struggle for direction and see less volatility, but the extremes of recent ranges are within the realms of possibility in 2023 with so many conflicting signals.

Euro Area growth is likely to stagnate in 2023, while growth in Asia and Latin America should improve in H2 '23.

COVID will continue to have a negative effect on labour market supply, and supply chain resilience, which could undermine growth and boost inflation

Figures quoted from Bloomberg
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