

Allianz Research | 27 October 2023

What to watch: The Fed between a rock and a hard place, Emerging Asia v. higher-for-longer, zero growth in the Eurozone and net impact of interest rates

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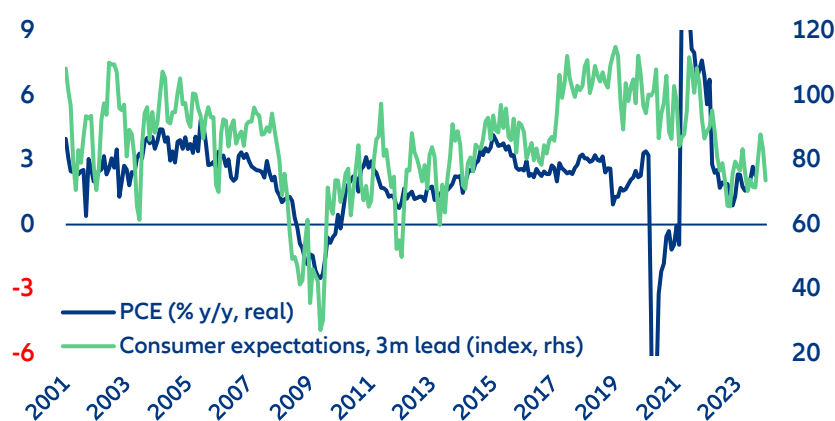
Executive summary

- **The Fed is caught between an (economic) rock and a (volatile) hard place.** The Fed is expected to keep rates unchanged next week in the midst of bond routs. However, strong economic data have fueled inflationary pressures and may still prompt the Fed to deliver a final rate hike in December. The recent rise in bond yields and corresponding decline in the stock market could knock -0.3pp off GDP and -0.2pp off inflation in H1 2024. However, we stick to our forecast of US 10y rates to normalize to 3.9% end-2024 and 3.6% end-2025. In an alternative scenario – higher for much longer and continued QT – we would expect rates to rise to 4.1% end-2024, and 4.0% end-2025, which is still a far cry from the current 5% mark.
- **Emerging Asia: higher-for-longer pressures yields and currencies.** Financial conditions in Emerging Asia are becoming less immune to developments in the US, complicating the job for central banks in the region. We believe that yields could even go beyond current levels and pressures on FX will grow. India and Indonesia's fixed income could become attractive in the near future. If the Fed keeps rates higher for longer, the Thai baht and Malaysian ringgit appear to be the most vulnerable.
- **Cloudy Eurozone growth outlook boosts disinflationary forces.** We expect Eurozone GDP to have flatlined in Q3 and early surveys for Q4 point to growth slipping below zero. Prolonged weak growth and excessive supply means better news on the inflation front: We expect headline inflation to drop to 3.2% y/y in October from 4.3% a month earlier. The overall picture confirms our view that the ECB will take its foot off the brakes in the second half of 2024, with moderate rate cuts.
- **Netting interest rates: The French and the Germans won, the Italians and the Spaniards lost.** It's been 14 months and 29 days since the ECB took negative interest rates away. In France, additional interest income exceeded additional payments by EUR12.5bn in the 14 months from July 2022 to August 2023, compared to the previous 14 months; in Germany, the surplus stood at EUR2.4bn. In Italy and Spain, however, rising rates were a drag on households' finances.

The Fed is caught between an (economic) rock and a (volatile) hard place

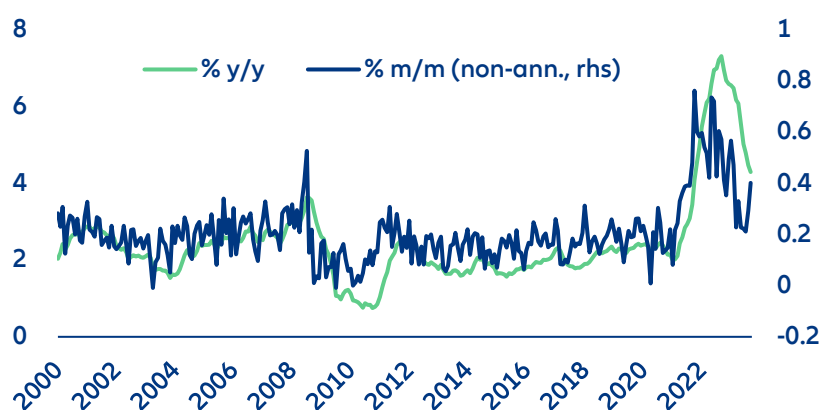
The Fed is expected to keep rates on hold next week amid bond market volatility, strong economic momentum and inflationary pressures. Several FOMC participants have recently suggested that the Federal Funds rate is likely to be left unchanged at the upcoming meeting, and even that it has likely reached its peak for this tightening cycle. Chair Powell's rather dovish tone at the Economic club of New York last week, pointing to a gradually cooling labor market and wage growth, also reflects increased caution regarding the recent tightening of financial conditions. The Fed is now getting concerned of stoking potentially large financial volatility, which could increase the risk of a hard landing. Yet, US Q3 GDP came out strong this week, at +4.9% annualized, with household consumption growing at a fast pace of +4%. Monthly data for September point to a strong end of Q3, setting the stage for resilient growth heading into Q4 despite mounting economic headwinds related to high interest rates and the resumption of student loan payments. Surveys suggest that US households are still confident about the short-term economic outlook, pointing to real personal consumption-expenditure growth only slightly decelerating through Q4 to a bit below +2% (Figure 1). Moreover, the September CPI reading was disappointing, with both services prices less shelter and shelter prices gaining +0.6% over the month (non-annualized), way above a level that the Fed would feel comfortable with. Underlying price pressure measures such as the Cleveland Fed's trimmed mean CPI also rebounded (Figure 2).

Figure 1: US real personal consumption expenditures growth & consumer economic expectations



Sources: LSGE Datastream, Allianz Research

Figure 2: Cleveland Fed's US CPI trimmed mean

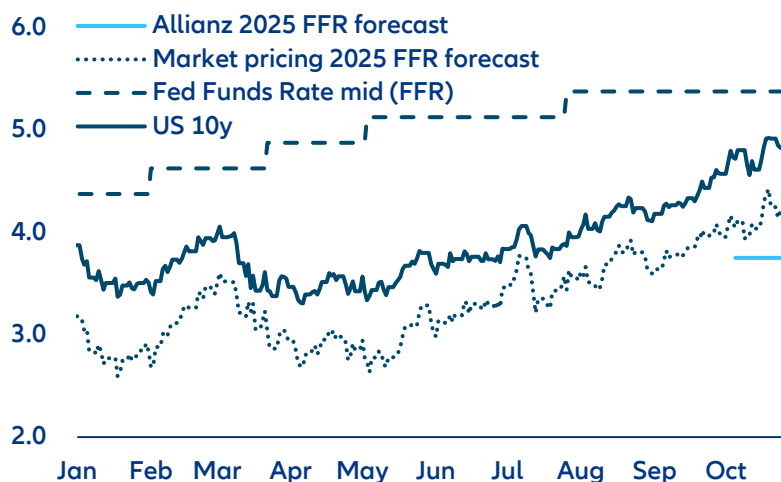


Sources: LSGE Datastream, Allianz Research

Using our in-house financial conditions index (FCI), we estimate that the rise in bond yields and the decline in the stock market since the summer will knock a further **–0.3pp off GDP and –0.2pp off inflation (non-annualized) in the first half of 2024**. This may be not enough to convince the Fed that GDP growth will slip well below trend and inflation will normalize rapidly towards 2%: after all, financial conditions were also restrictive in 2022 (-1pp off GDP) when the stock market slipped, but this did not prevent GDP from growing robustly. We still think that a final rate hike (25bps) at the December meeting is more likely than not if bond market volatility subsides. We also continue to expect quantitative tightening to be halted in mid-2024, with the Fed Funds rate reaching 4.75% at end-2024 and 3.75% at end-2025.

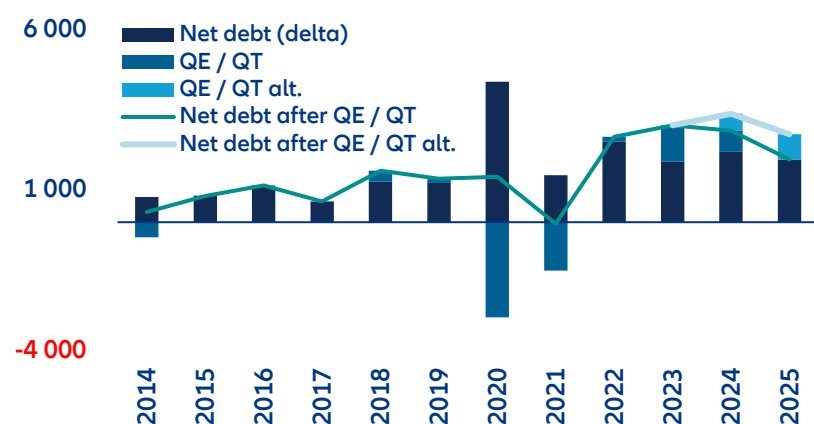
What does this mean for the US yield outlook in 2024 and 2025? In this unchanged baseline scenario, we continue to expect 10y bond yields to normalize by falling to 3.9% at the end of 2024 and 3.6% at end-2025. But as bond markets have recently sold off on expectations of (i) fewer rate cuts than initially assumed (Figure 3) and (ii) additional bond supply coming from the speculation that the Fed might continue with QT, it is worth looking at such an alternative scenario. Currently, the Fed is reducing its balance sheet by around USD90bn on average per month. If the Fed continues QT at this rate and does not stop in mid-2024 according to our expectations, this will result in USD1trn of bond supply in 2024 and 2025, on top of the USD2trn of net issuance amid high fiscal deficits (Figure 4). If we also assume that the Fed Funds rate follows current market pricing to reach 4.4% at the end of 2025, which translates to cumulative cuts of 130bps instead of the 200bps we penciled in, our fair value model would see 10y rates to fall to 4.1% (4.0%) at end-2024 (end-2025). That would be 20-40bps higher than our current baseline forecast (Figure 5). However, this would still be a far cry from current yield levels around 5% and corresponding forward rates at similar levels. In conclusion, if the Fed indeed stays higher for longer without stopping QT, the recent bond market sell-off may seem more rational, but it still appears excessively vigorous when stacked up against fundamentals.

Figure 3: Fed Funds rate: market expectations and Allianz Research forecast, in %



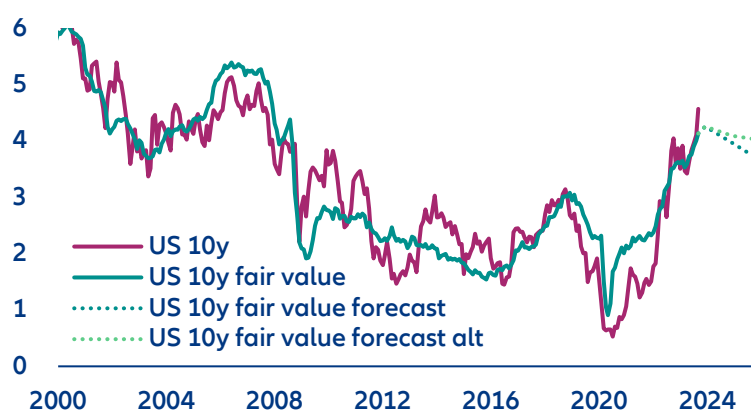
Sources: LSGE Datastream, Allianz Research

Figure 4: Change in US debt and QT in Allianz Research baseline and alternative scenario



Sources: LSGE Datastream, Allianz Research

Figure 5: US 10y yields and fair value model estimates

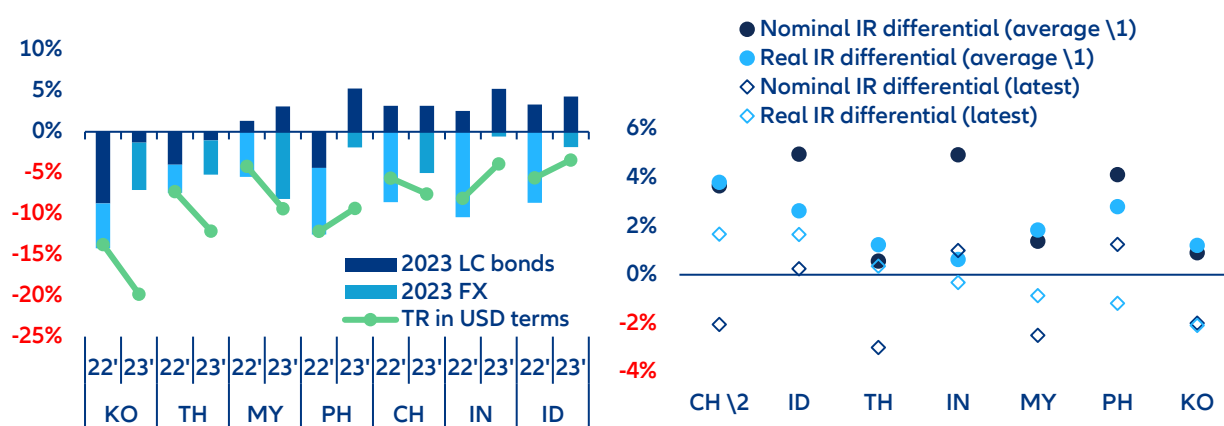


Sources: LSGE Datastream, Allianz Research

Emerging Asia: higher-for-longer pressures yields and currencies

Higher-for-longer interest rates in advanced economies will complicate the job for Asian central banks as expectations of slowly falling yields vanish Facing relatively lower inflationary pressures, central banks in Asia started tightening monetary policy much later than their peers in advanced economies. But while this helped restrain the increase in local currency sovereign yields and borrowing costs, it was not effective to mitigate the substantial financial challenges arising from the significant rise in US yields and the narrowing interest rate differentials (Figure 6). As inflation rates have now come down considerably (only India, the Philippines and South Korea have reported y/y inflation significantly above 2.5%, with China and Thailand at 0%) and economic risks mounting, central banks should start cutting interest rates. The volatility in US yields and markets taking on the 'higher for longer' narrative are not just delaying potential rate cuts but also reversing the early downward trend in emerging market (EM) local yields (as shown in Figure 7).

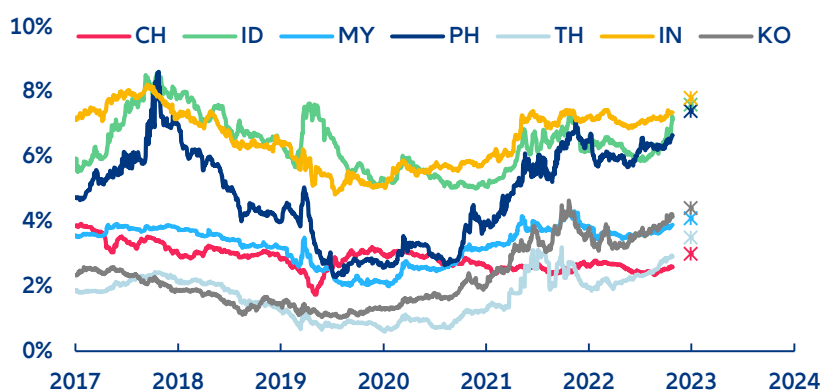
Figure 6: Evolution of total returns of EM Asia sovereigns (lhs) and policy rate differential vs the US (rhs)



Sources: LSEG Datastream, Allianz Research. Notes RHS: \1: average calculated taking the end-of-the-month differentials since 2006. \2 1Y Loan prime rate used for Chinese IR.

There is no escaping the gravity of the US bond market, so do not expect positive news from Emerging Asia sovereigns. While US long-term rates are unlikely to go further beyond the 5% mark, bond volatility and continued financial pressures could temporarily push Asian local yields beyond the highs seen in October 2022, even though rates in (most) Emerging Asia markets have not surpassed 2010 levels. As shown in Figure 8, correlations with US Treasuries have increased in recent years, contributing to volatility in the current economic environment. Recent upside risks of higher oil prices – not only via the inflation effect on local yields but via foreign exchange for importers – and the deteriorating sentiment around EMs are adding to the pressure.

Figure 7: Evolution of 5Y sovereign yields across EM Asia



Sources: LSEG Datastream, Allianz Research. Note: Star represents the maximum that they could reach under the baseline. The star is shown on end-2023 but the maximum could be reached anytime between now and Q2 2024.

Chinese yields are the exception – but this comes with a price. This cycle has confirmed that Chinese yields are one of the least-correlated with US yields. However, this comes with strong pressures on the currency (for foreign investors) and they are one of the least attractive sovereign when compared to the country's equity returns (for local investors¹). Fiscal stimulus plans coupled with additional borrowing are expected to alleviate the downward pressure on yields, both through increased supply and nominal growth. While the unique nature of the Chinese situation may be approaching its end to some extent, there are currently no other countries that provide relief from growing yield pressures. While India will benefit from some tailwinds coming from the opening of its capital markets², it is especially sensitive to oil prices (Figure 8). The Philippines' yields have already increased significantly but may face setbacks from costly commodity imports and fiscal concerns, making them less attractive for the

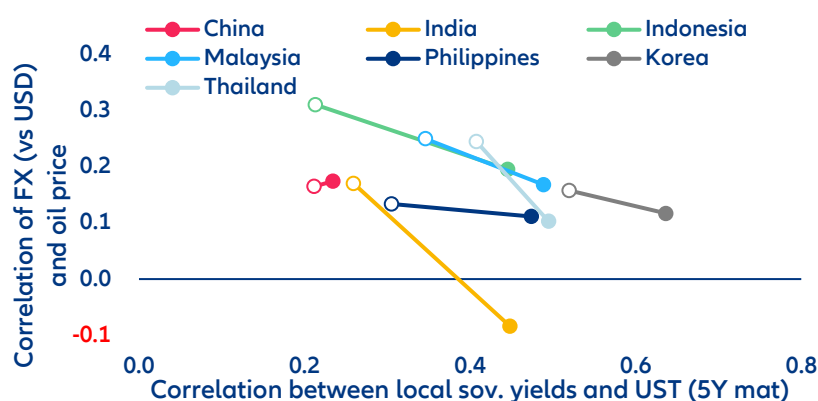
¹ See our story on the equity risk premium and the paradox in the pricing of Chinese equities: [link](#).

² See our story on expected benefits for India of its inclusion in a major sovereign bond benchmark: [link](#).

foreign investor. To become more attractive, global yields would need to adjust downwards and economies would need to be relatively better at managing weaker global growth (including China's slowdown). In principle, India and Indonesia (well positioned in the commodities market for both "brown" and "green" commodities) seem better positioned, making their bonds more likely to deliver positive returns and to attract foreign investors.

Watch out for vulnerabilities on the FX front. As shown in Figure 6, Asian currencies have been less resilient than major Latin American currencies (ex-ARS³) and even those of major Eastern European (ex-TRY) that are more directly affected by the war in Ukraine. But if the Fed keeps interest rates high for longer, currencies would remain under pressure, all the more so given increased interdependencies with a weak CNY (although we expect the government to prevent any major further declines). In this context, the THB would face the most significant pressures due to its combination of relatively low interest rates and a current account deficit. The MYR would also feel high pressures when considering additional factors such as external debt commitments and reserves. However, in such an event, the major risk is common across the region: how to deal with pressures on currencies through interest rate hikes in the face of weak economic growth.

Figure 8: Correlation between yields and FX of EM Asian countries with key exogenous variables. Empty dots represent the correlation since 2005, filled dots only for the last 3 years



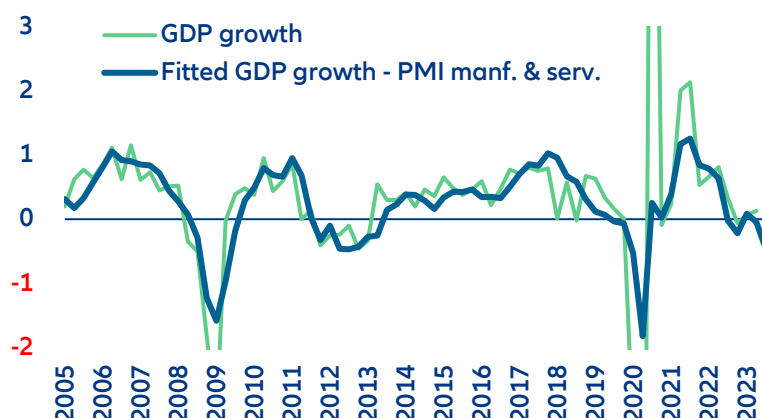
Sources: Refinitiv Datastream, Allianz Research

Cloudy Eurozone growth outlook boosts disinflationary forces

The Eurozone is likely to report a fourth consecutive quarter of stagnating growth next week. Leading indicators such as purchasing manager indices (PMIs) suggest there is even a risk of a contraction in Q3 GDP, which comes out on 31 October, the result of the lagging impact of highly restrictive monetary policy on credit demand and thereby investment, as well as the slowdown in Germany. And the outlook for Q4 is not any brighter: The disappointing October PMIs set the stage for -0.5% q/q growth in Q4, which would be well below our current forecast of +0.2% q/q (Figure 9).

³ ARS: Argentinian Peso; TRY: Turkish Lira; THB: Thailand Baht; MYR: Malaysian Ringgit.

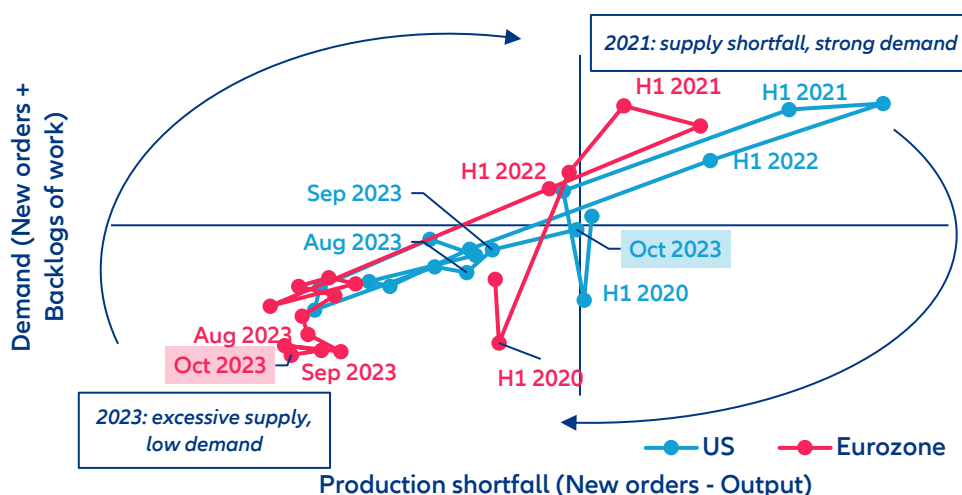
Figure 9: GDP growth and PMI implied growth, in % quarter-on-quarter



Sources: LSGE Datastream, Allianz Research

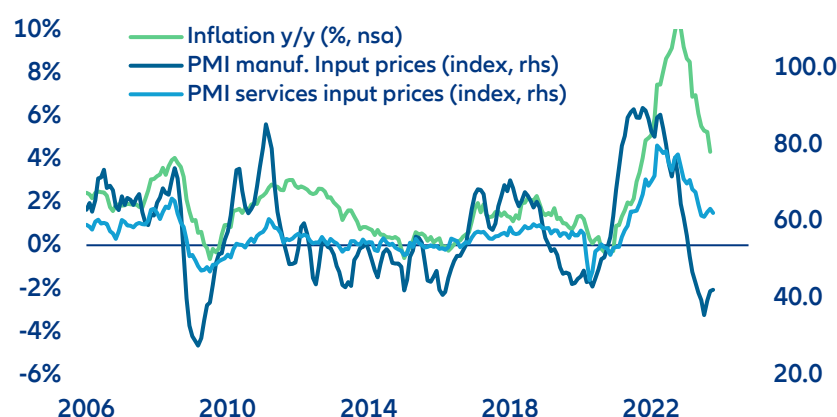
But this weaker growth outlook paves the way for speedier progress towards the ECB's inflation target. We expect headline inflation to drop to 3.2% y/y in October from 4.3% a month earlier, largely due to base effects but also thanks to lower gasoline prices. Core disinflation will be somewhat slower as we expect a drop to 4.3% in October from 4.5% a month earlier. Going forward, we see downside risks to our 2024 outlook for annual headline inflation at 3.0% (ECB 3.2%, Consensus 2.5%), given that lower, demand-driven growth will drag inflation down faster through a wider negative output gap. New orders, backlogs of work and output data from PMI surveys suggest excess supply and subdued demand which would be the opposite situation from two years ago (Figure 10) and points toward more rapid disinflation. Moreover, leading measures of price pressures in the PMI sub-indices also suggest that disinflation is on track. Input prices in manufacturing are dropping rapidly, with levels significantly below the expansionary level of 50. Services sector input prices remain in expansionary territory, albeit lower than before, but the chart clearly shows that this is a lagging indicator compared to manufacturing just like in the corresponding CPI components (Figure 11). In any case, the overall picture confirms our view that the ECB will take its foot off the brakes in the second half of 2024, with moderate rate cuts. By then, inflation will approach the lower spectrum of the 2-3% range, close to the ECB target of 2%, assuming no further escalation in ongoing geopolitical conflicts in the Middle East and Ukraine.

Figure 10: Manufacturing PMI clock chart



Sources: LSGE Datastream, Allianz Research

Figure 11: Inflation and PMI sub-indices on input prices



Sources: LSGE Datastream, Allianz Research

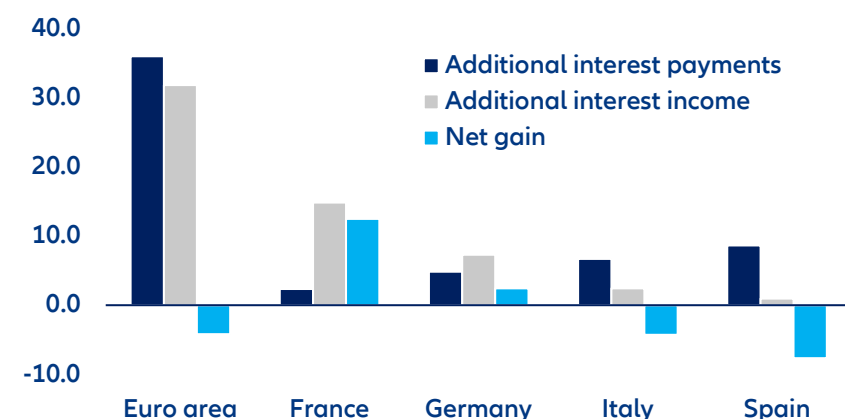
Germany remains the weak link in the Eurozone – followed by Italy – but Spain and France are also slowing down. German GDP is expected to have dropped by -0.2% in Q3, thereby extending the economic decline that started last year amid high energy prices and subdued international demand. Similarly, Italy is flirting with a recession but is expected to stagnate after the -0.4% drop in Q2. France will see a deceleration from its surprisingly strong second quarter to +0.2% q/q and the outlook for the next couple of quarters points towards stagnation. Spain already reported a +0.3% q/q pick-up in growth: it was better than expected, but the Q4 outlook looks more challenging as wage growth is slowing and inflation is set to rise.

Netting interest rates: The French and the Germans won, the Italians and the Spaniards lost

It's been 14 months and 29 days since the ECB took negative interest rates away. How have households fared? Surprisingly, French and German households earned quite a few dinners in fancy restaurants. Conventional wisdom says rising interest rates are good for banks because they increase the interest margin, i.e. the difference between interest paid to depositors and interest received from borrowers. Looking at the Eurozone as a whole, interest on outstanding deposits increased by 64bps while those on outstanding loans rose by 78bps over the period⁴. As a consequence, the margin increased by 14bps from 1.90bp to 2.04bp. So far, so expected – though the margin expansion is relatively small. But there are huge differences between the biggest four Eurozone countries. In France and Germany, the interest margin *shrank* by a whopping 72bps and a still remarkable 32bps, respectively. In sharp contrast, it surged by 107bps in Italy and 166bps in Spain. This has had a real impact on households' bottom line. In France, additional interest income exceeded additional payments by EUR12.5bn in the 14 months from July 2022 to August 2023, compared to the previous 14 months; in Germany, the surplus stood at EUR2.4bn. In Italy and Spain, however, rising rates were a drag on households' finances (Figure 12).

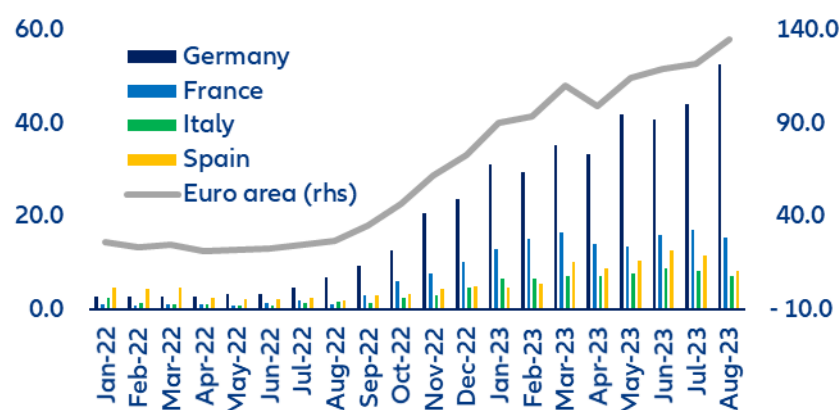
⁴ From July 2022 to August 2023.

Figure 12: Additional interest income and payments in the 14 months from July 2022 to August 2023 compared to the previous 14 months, in EURbn



Sources: ECB, Allianz Research

Figure 13: Deposits*, in EURbn (new business)



Sources: ECB, Allianz Research. *Deposits with agreed maturity.

What is behind this unusual outcome? A look at the asset side of households' balance sheet i.e., deposits, shows that interest rates on new deposits with agreed maturity soared by 273bps on average, with only limited variation between countries. However, the degree to which these offers were taken by households differed greatly between countries (Figure 13). German households were really enthusiastic; outstanding deposits with agreed maturity increased by more than EUR 200bn within a year and their share in overall deposits almost doubled to 18%. Nothing comparable can be witnessed in any of the other countries⁵ (Figure 13), where households also took up debt securities (for Italy, see our report⁶; for France, pension funds). Thus, German households' gains are mainly a story of agile savers, flocking to attractive offers en masse: German savers know a bargain when they see one.

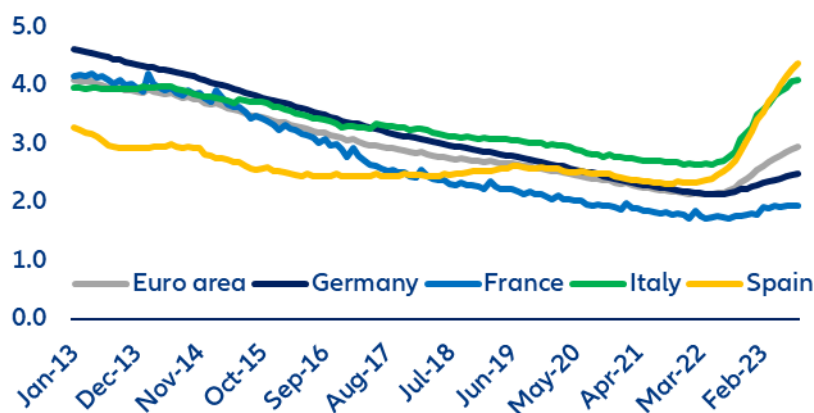
At the same time, Italian and Spanish households were hit harder by rising rates on new loans. Rising interest rates on new loans (by 240bps on average) led to dwindling business volumes in all countries (by more than a third on average). But the interest movements on outstanding loans showed very different patterns. While the increase in France amounted to a paltry 19bps and in Germany only 36bps, in Italy they amounted to 142bps. In Spain, average lending rates in August were even 190bps above the level of June 2022 (Figure 14). This reflects different pass-through dynamics from policy rates to lending rates but also some structural factors (i.e. the cap in mortgage loan rates in France). The share of mortgages at variable rates also plays a significant role (Figure 15). French households' gains are mainly a story of resilience as they benefited nicely from fixed interest rates on their lending,

⁵ Italian households, however, shifted money out of the banking system into sovereign bonds to secure higher interest rates.

⁶ [What to Watch 13 October 2023](#)

while pocketing rising rates on their deposits, not least from the *Livret A*. In Italy and Spain, however, the proportion of new loans at variable rates – though declining from historic levels – seems to reflect both monetary policy expectations (on the demand side) but also unaffordable and tightened lending conditions on the supply side.

Figure 14: Weighted average interest rates on outstanding loans*, in %

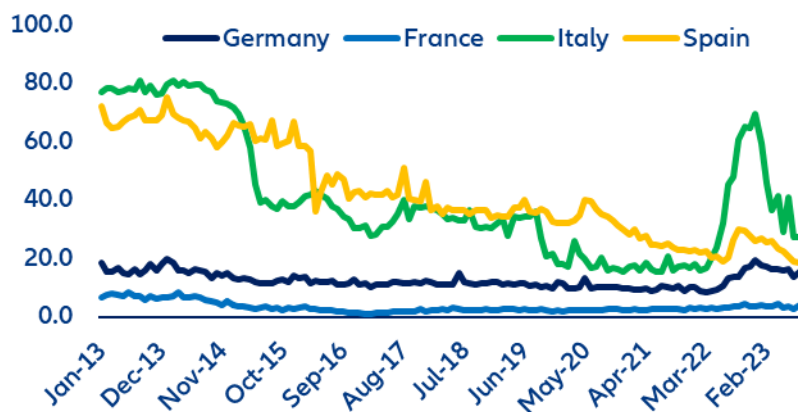


*Lending for house purchase, credit for consumption, other lending.

Sources: ECB, Allianz Research. *Lending for house purchase, credit for consumption, other lending.

The honeymoon period for some households will not last forever. Loans with fixed interest rates will someday come due and need refinancing at much higher rates. And interest rates on deposits may have already reached their peak, while even the most frugal of German households can only shift so much of their savings into higher-yielding deposits. The upshot: French and German households are likely to join their Italian and Spanish peers in feeling the pinch of higher interest rates – at least in their dealings with banks.

Figure 15: Share of variable rate loans (new business)



Sources: ECB, Allianz Research

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