

A low-angle shot of numerous glowing red lanterns against a clear blue sky. The lanterns are spherical with a ribbed texture and feature intricate black metal filigree at their bases. They are strung together and hang from thin wires.

The Global Edge

Financial Insights from WisdomTree

China Re-opens: What It Means for Global Investors

February 2023

An empowering blend of global financial research and analysis, insights and macro-commentary on a breadth of today's most compelling economic and investing developments, from an international team of WisdomTree thought leaders.

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China's COVID Policy Reversal and Current Macroeconomic Pulse

In November 2022, China's Zero-COVID policy was swiftly reversed. It began with a rumor on November 1, that a reopening committee had been formed, led by Vice Premier Wang Huning. Though details will never been known, on November 4, scientist Zeng Guang's talk at CITIC confirmed many points of the policy shift, thus starting the journey of reversing Zero-COVID policy.

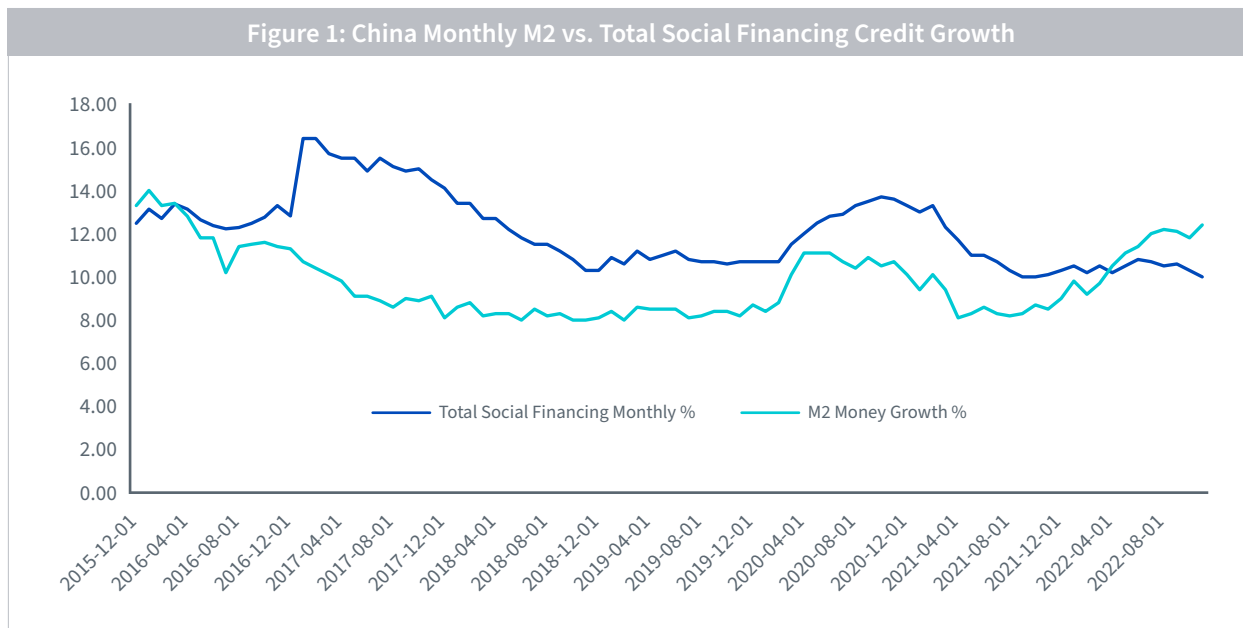
Protests by workers at Foxconn and in Guangzhou, or student protests, were concurrent with many official pronouncements of loosening. Historians will debate what factors contributed to the policy shift, but financial markets had been ahead and more firmly convinced of the opening than many political observers. The speed of the reversal was so swift that even the Party's chief propaganda outlet, *People's Daily*, was behind in communicating the news to the public.

The Omicron variant rolled through China at lightning speed, and by late December, China was experiencing a dichotomy of very crowded entertainment stadiums, hospitals and crematories. **The economic recovery has begun in earnest and can be summarized in three main angles.** One, Chinese consumers have money saved up due to the ever-tighter consumption limits of the later stages of Zero-COVID. Two, little of these savings is likely to go into long-term investments like housing, as future price expectations for this old staple of Chinese households is experiencing an unprecedented reverse. Three, unlike the Federal Reserve (Fed), China's central bank plays second fiddle to the People's Bank of China (PBOC) in managing growth. Although, the central bank affirmed its ability to manage China's currency stability, thus giving itself another layer of credibility with regard to currency management.

In more detail, here are the three main angles of China’s recovery process:

1. China’s M2 liquid money supply has been growing faster than credit, because of people saving instead of spending or investing under Zero-COVID.

As a portion of these savings materialize in travel and luxury splurges, companies will enjoy earnings boosts.

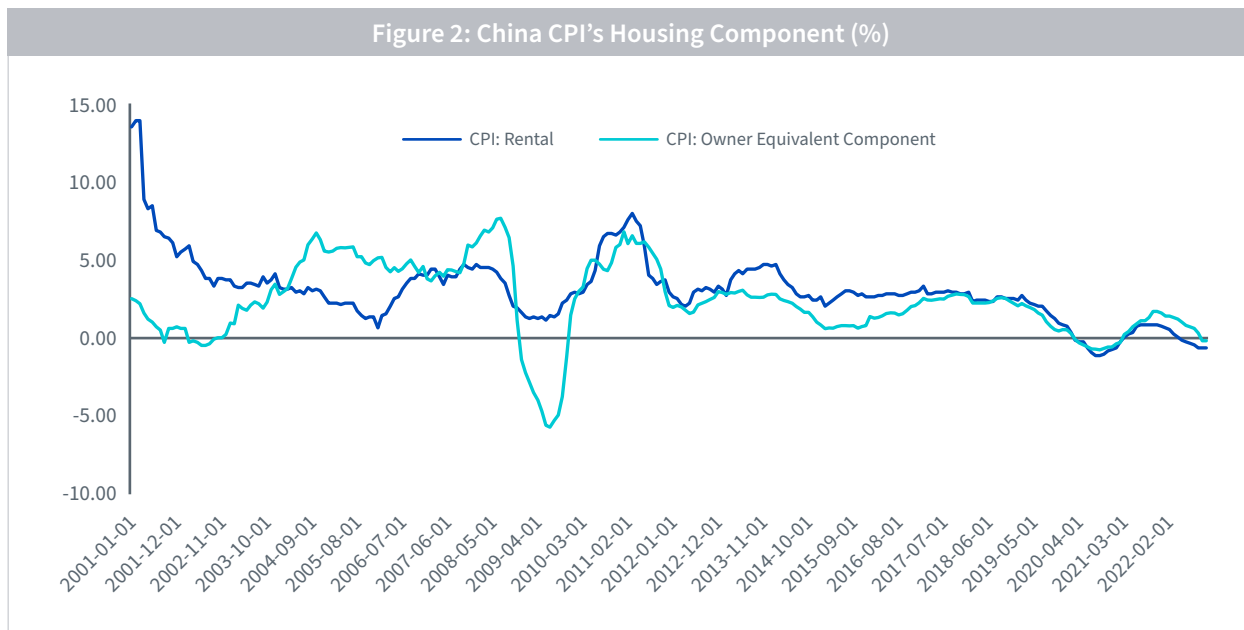


Source: Datayes, data 12/1/15–11/30/22. **Historical performance is not an indication of future performance and any investments may go down in value.**

2. However, in contrast to spending more on travel and other splurges, the housing market is unlikely to get a significant demand boost, mainly because there’s been a sea change in expectations for housing prices. The old belief that house prices can only go up is now in doubt.

Only twice in the past 20 years, during the 2020 initial COVID shock and now, have both the housing price and rental components of the Consumer Price Index (CPI) been negative. Because official CPI data is highly smoothed, real-world rent and housing prices were falling even more, particularly outside the top tier cities of Beijing and Shanghai.

The government has come out with three arrows for the housing sector, essentially capital support for struggling developers. But these credit supports are mainly to avoid a housing-induced liquidity crisis, so it's fair to say the worst and sudden shock has passed for China's housing sector. But housing as a main Chinese household investment has passed, and housing demand recovery will mostly slow. As a result, the commodities that are most closely tied to the housing sector will likely experience less pricing pressure.

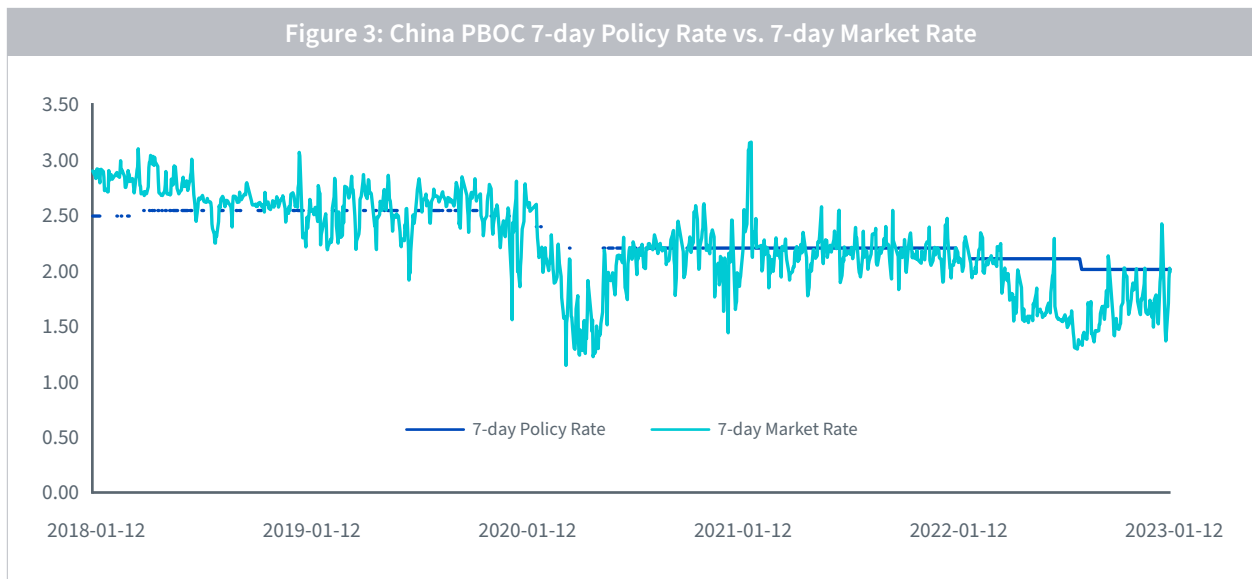


Source: Datayes, data 1/1/01–11/30/22. **Historical performance is not an indication of future performance and any investments may go down in value.**

3. PBOC plays second fiddle in managing economic growth but has credibility in managing Chinese currency.

In previous blog posts, we've explained the different role of China's central bank compared to that of the Fed. The PBOC generally tries to come up with policies that avoid the worst, but it does not take on the first role of stimulating the Chinese economy. That is, it will provide credit to avoid a financial liquidity crisis but will not take action to drastically lower rates.

The PBOC’s seven-day policy interest rate moves in very small steps and the central bank only acts when both the market rate is deviating significantly from policy rate and the economic situation is so bad it has to do something to signal that it acknowledges the problem and will prevent the worst. Mostly, it carves out time for government policies to work, rather than implementing monetary stimulus.



Source: Datayes, data 1/12/18–1/12/23. **Historical performance is not an indication of future performance and any investments may go down in value.**

In 2022, amid U.S. dollar strength, China’s yuan currency volatility was moderate. The PBOC tried not to manipulate the currency much, allowing it to fluctuate but did take action when it perceived the currency was in a range that was too far away from fundamentals. Its success will give the PBOC continued credibility in managing Chinese currency in the future.

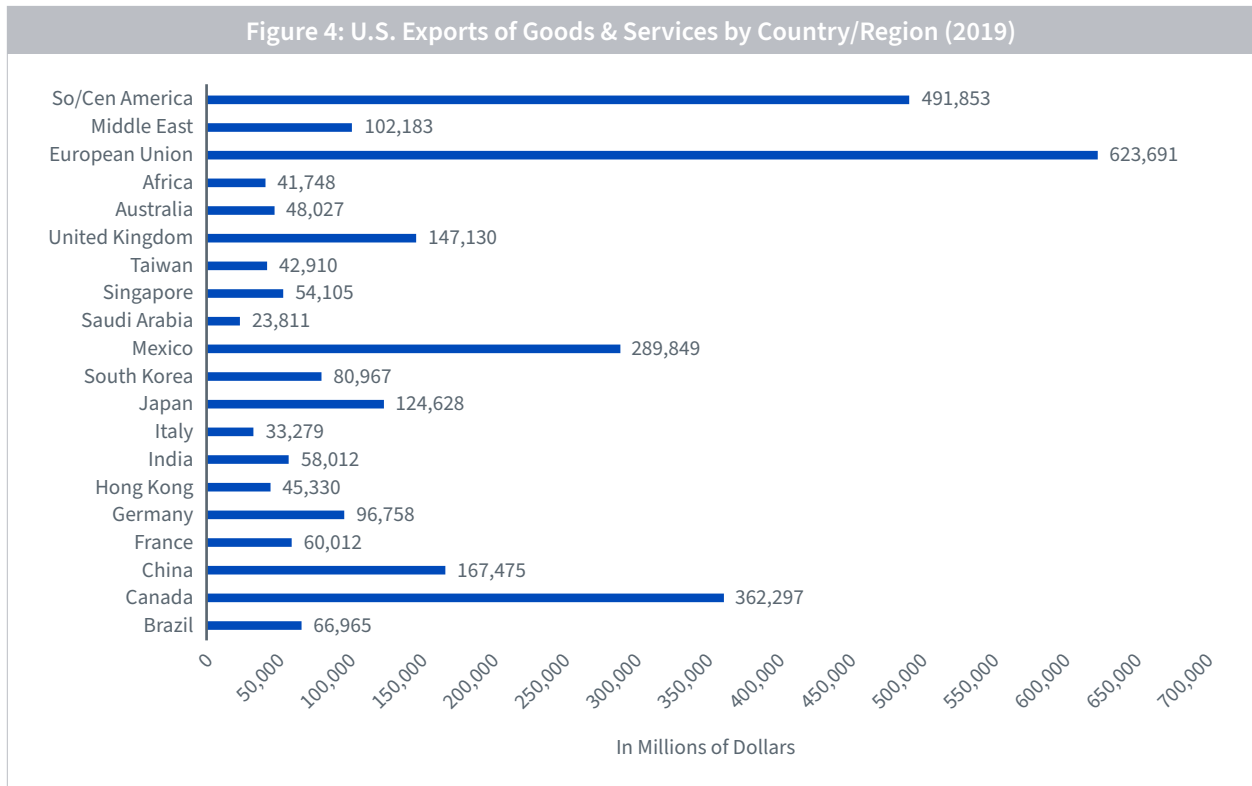
Any Macro Impact for the U.S. Just Yet?

Rightly or wrongly, in the U.S., the potential impact of China’s reopening has not yet garnered much attention. The money and bond markets have thus far been consumed by domestic economic data, focusing on the recession-versus-inflation narrative. In addition, the return of the debt ceiling debate has also come into focus and will likely dominate the headlines as we approach the exhaustion of the Treasury Department’s ‘extraordinary measures’ sometime this summer.

Against this backdrop, the Fed continues to command center stage, and will likely remain in that position for all of 2023, if not also the beginning of 2024. Based on commentary from the U.S. central bank, officials are monitoring the potential impacts of China’s reopening. At this point, however, it does not appear to be a factor that could alter the policy makers’ plans.

KEEPING OUR EYES ON TRADE

Arguably, the spillover effect from China’s reopening may not prove to be what one would have expected prior to the Fed’s Volcker-esque¹ rate hike campaign over the last year. The degree of tightening here in the U.S., as well as for a host of other developed economies, has had at its nexus the desire to soften the demand side of the equation. While Q4 U.S. real gross domestic product (GDP) posted its second consecutive performance on the plus side of the ledger, at 2.9%, the underlying components seem to be pointing toward slowing in demand. Final sales to private domestic purchasers rose a scant 0.2%.



Source: Bureau of Economic Analysis, as of 1/26/23. **Historical performance is not an indication of future performance and any investments may go down in value.**

¹ Refers to the years that Paul Volcker Jr., an American economist, served as the twelfth chairman of the Federal Reserve, from 1979 to 1987. During his tenure as chairman, Volcker was widely credited with ending the high levels of inflation seen in the U.S. throughout the 1970s and early 1980s.

That brings up the question of foreign demand and, in our discussion, China. In fact, the one area where market participants might turn their attention is to trade. China and trade continue to be a hot button topic, given the wide trade deficit the U.S. runs with China. For the purpose of this publication, our focus will be on the export side of the ledger. Remember, 'net imports' is a negative contributor to the GDP calculation.

Figure 4 highlights U.S. exports of goods and services to various key countries and regions throughout the globe. We purposely used 2019 as our reference period for data from the Bureau of Economic Analysis (BEA) to provide insights into the pre-COVID world of trade. In 2019, U.S. exports to China came in at roughly \$167.5 billion. While on the surface this amount seems formidable, it is only the fifth-highest tally on a global basis. For some perspective, exports to the European Union came in first and was more than 3.7 times greater at \$623.7 billion. Interestingly, exports to China were also more than eclipsed by the North American countries, Canada (\$362.3 billion) and Mexico (\$289.8 billion). In fact, exports to the U.K. were not too far behind the China number, coming in at \$147.1 billion in 2019.²

FINAL THOUGHTS FOR U.S. RATES

As we mentioned earlier, upcoming Fed policy decisions will more than likely be focused on the U.S. domestic side of the equation. For investors, the battle between the two time-tested adages of 'don't fight the Fed' versus 'don't fight the tape' within the U.S. Treasury market will continue to play out over the course of this year. We expect the former adage to hold sway early on before giving way to the latter during the second half of the year, when the rally in duration presents a clearer picture.

However, as we've seen over the last two years, macro developments have a way of changing quickly, and with them, attendant Fed policy decisions. While potential effects on commodity prices (discussed later) and inflation certainly come to the forefront, some of the other impacts on the U.S. macro front might not become readily apparent in short order.

² Source: Bureau of Economic Analysis, as of 1/26/23.

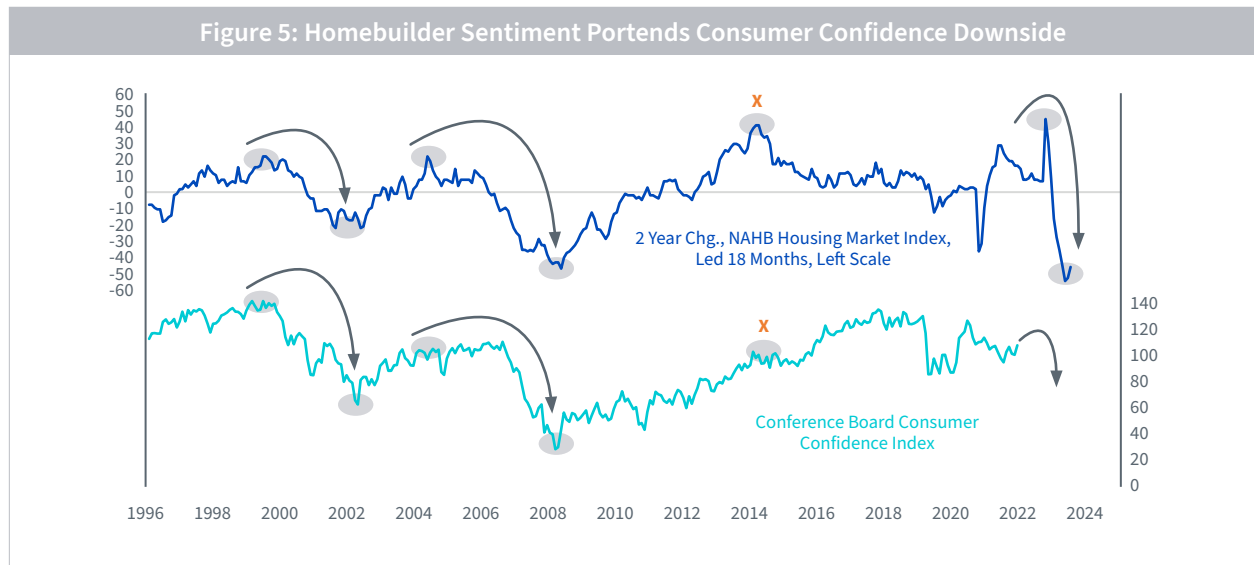
U.S. Outlook

One of the challenges confronting consumer spending in 2023 is the contrast between the proverbial Chinese global traveler showering retailers with savings built up during lockdown and the cold reality that home prices are falling not only in globally notable metros such as New York, London and Shanghai, but in many other places in between.

According to Redfin, median home prices across the western seaboard have been in freefall since last spring. San Diego’s median home price, for example, has slipped from \$925,000 in April to \$785,000, a 15.1% decline. Further up the California coast, buyers who have been waiting for a post-COVID residential property decline will find in Los Angeles a 13.3% discount from last spring’s peak. In San Francisco, the bear market is bolder: a 21% fall from \$1,612,500 last spring to \$1,280,000 at year-end.³

Though we are highlighting the west coast, which has been the epicenter for home price declines over the last three quarters, make no mistake: prices are in a state of steady deflation from Dallas to Chicago to Miami to New York.

Our key concern is that the collapse in homebuilder sentiment portends a deterioration in consumer confidence.



Sources: Refinitiv, National Association of Homebuilders as of January 2023. Conference Board as of December 2022. **Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

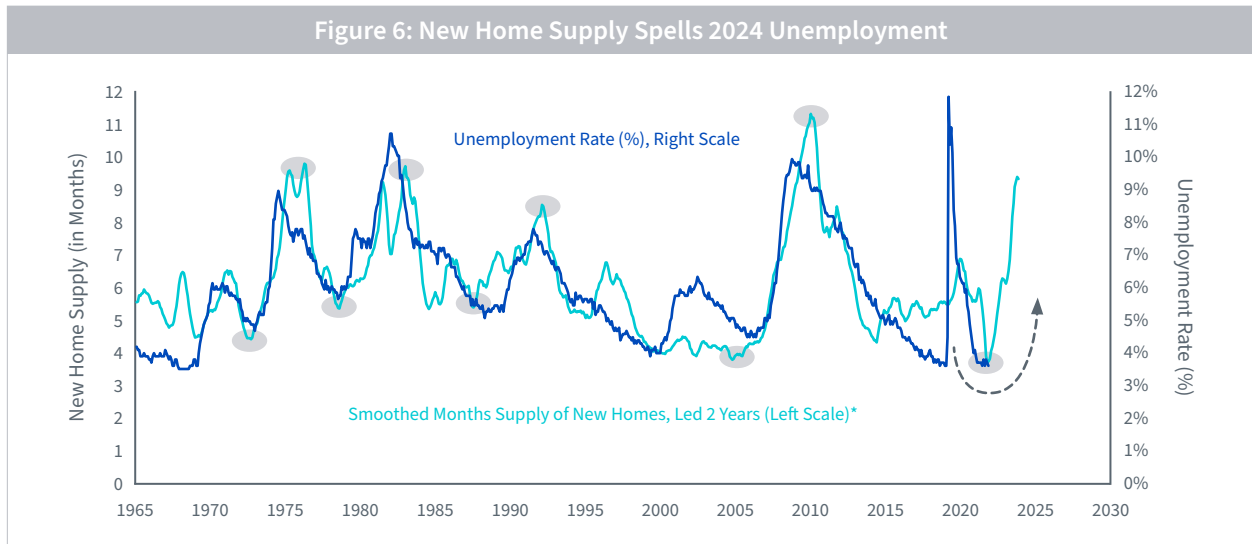
We do not think that waning sentiment in Middle America is properly priced in by stocks either, despite the now-cliché statement by the Street that 2023 will witness “the most anticipated recession in our careers.”

If it’s being anticipated by “all of us,” someone should tell the Federal Open Market Committee (FOMC). Between the committee’s 2023, 2024 and 2025 unemployment forecasts, the highest figure in its ranges for any of those three years is 4.8%.⁴ For those of us with a little grey hair, we used to call that maximum employment.

Our concern is that the Fed seems to be ignoring the icy housing market. In short, the overwhelming majority of prospective buyers cannot afford to stump up enough to service the monthly housing payment in a 6+% mortgage world. The surfeit of new home supply is an indicator that demands respect; it points to thematically higher unemployment.

³ Redfin, based on calculations of home data from MLS and/or public records, as of December 2022.

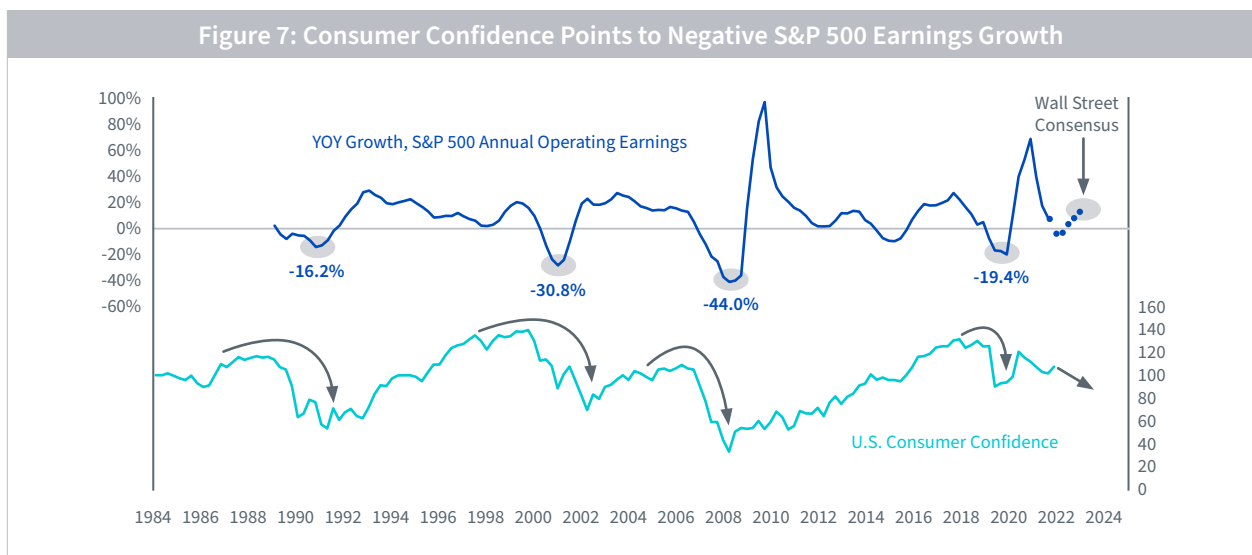
⁴ Source: Federal Reserve, Summary of Economic Projections, 12/14/22.



Sources: Refinitiv, U.S. Census Bureau, Department of Housing and Urban Development, BLS, as of December 2022. *6 Month Average of New Home Supply. **Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.**

This freeze in housing activity, a freeze of necessity on behalf of the locked-at-3% seller and the also-locked buyer, spells trouble for professions ranging from pest control to chimney repair to heating and cooling specialists, plus a hundred more housing-tied careers. The reason: homeowners do not typically seek out roofing patchwork unless a home inspector forces their hand.

As worse-than-expected labor market deterioration begins to be reflected in forthcoming consumer confidence readings, we think it presents a thesis that calls for downside risk in calendar 2023 S&P 500 earnings.



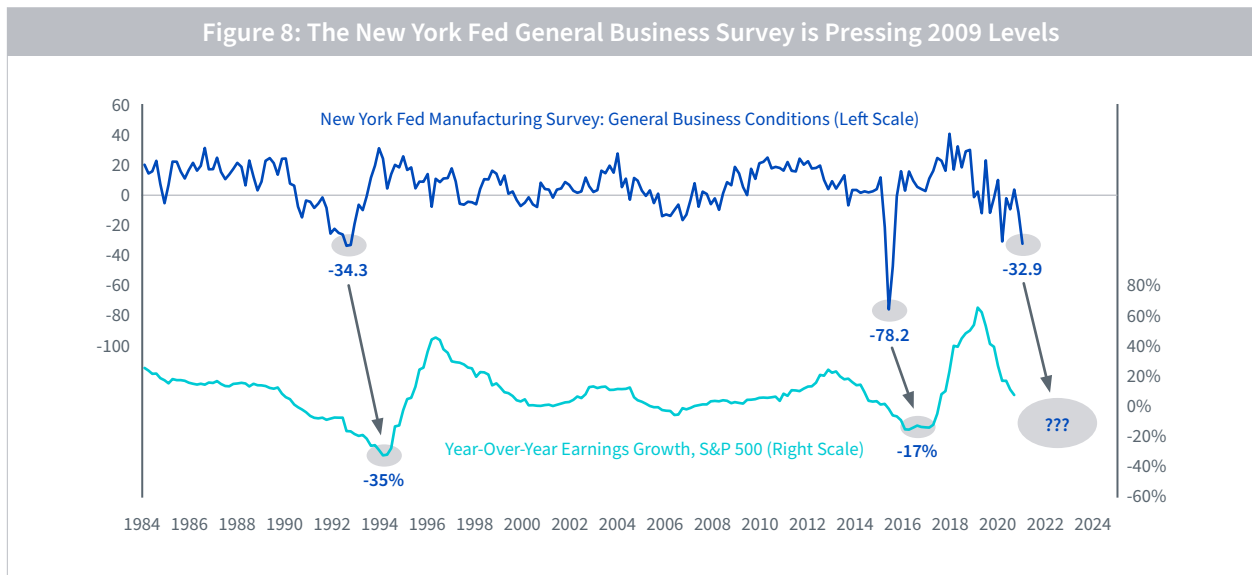
Sources: Refinitiv, S&P Global, Conference Board, as of January 2023 for S&P earnings, including Q4/2022 Street consensus. Consumer Confidence as of December 2022. **Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties. Investors cannot directly invest in an index.**

There are a number of issues when it comes to the matter of this year’s broad market earnings. For one, the consensus for the quarter currently being reported has S&P 500 operating earnings of \$199 for 2022, rising to \$224 in 2023.

The promising part of the situation is that many are already bracing for that \$224 to be revised down, diminishing the potential for lower earnings to come as an adverse surprise. The less promising part is that we do not come across too many seers who hypothesize an outright year-over-year decline in earnings to something lower than \$199 in 2023.

A forthcoming wane in consumer confidence would beg to differ.

Consider the warning being given to S&P 500 earnings by the New York Fed manufacturing survey. Aside from COVID’s initial months, the measure is just a hair off levels witnessed during the global financial crisis. It seems distinctly possible that 2023 could be a tough year for those with rosy expectations.



Sources: Refinitiv, NY Fed, as of January 2023. **Historical performance is not an indication of future performance and any investments may go down in value. Investors cannot directly invest in an index.**

Granted, we have been at this long enough to note that gauging the public’s hopes and fears is difficult enough without the curveball of 1.4 billion Chinese exiting COVID lockdown and perhaps spending down robust bank account balances.

It’s not hard to imagine a wealthy Chinese couple shopping this spring and summer in luxury Parisian boutiques. But make no mistake: that couple’s apartment has lost value every month for 15 months. Maybe this flush-with-cash couple will still take the family trip to Orlando or Tokyo, but they won’t take out their wallet quite as often as in 2019.

Meantime, in a world far away from this image of globetrotting post-COVID spending splurges, it looks like a tough year for the carpet installation team in Atlanta or the landscaping crew in Phoenix. In a housing market where few homes are listed and even fewer are bought, a 50-hour workweek turns into 30 hours—with scant chances at time-and-a-half.

Totally lost on the St. Louis Fed's Blue Chip Survey of Professional Forecasters is the coming plight for real estate attorneys, bricklayers, excavation teams, realtors and so many more; that collection of prognostications has U.S. unemployment hanging tough, rising gently from 3.4% to 4.4% this year. It's as if house prices aren't falling every single month, across the board.

As these societal issues become acknowledged during 2023, we imagine a tone of caution and reason will confront stocks.

That sentiment proved harrowing for two 2009–2021 winners, tech and consumer discretionary, when the market took a cautious tone last year. As the public comes to realize the extent of the freeze-over in the domestic residential property market—and its attendant job losses—we suspect those bull market winners will be among the first to be reflexively sold in any forthcoming market panics and sell-offs.

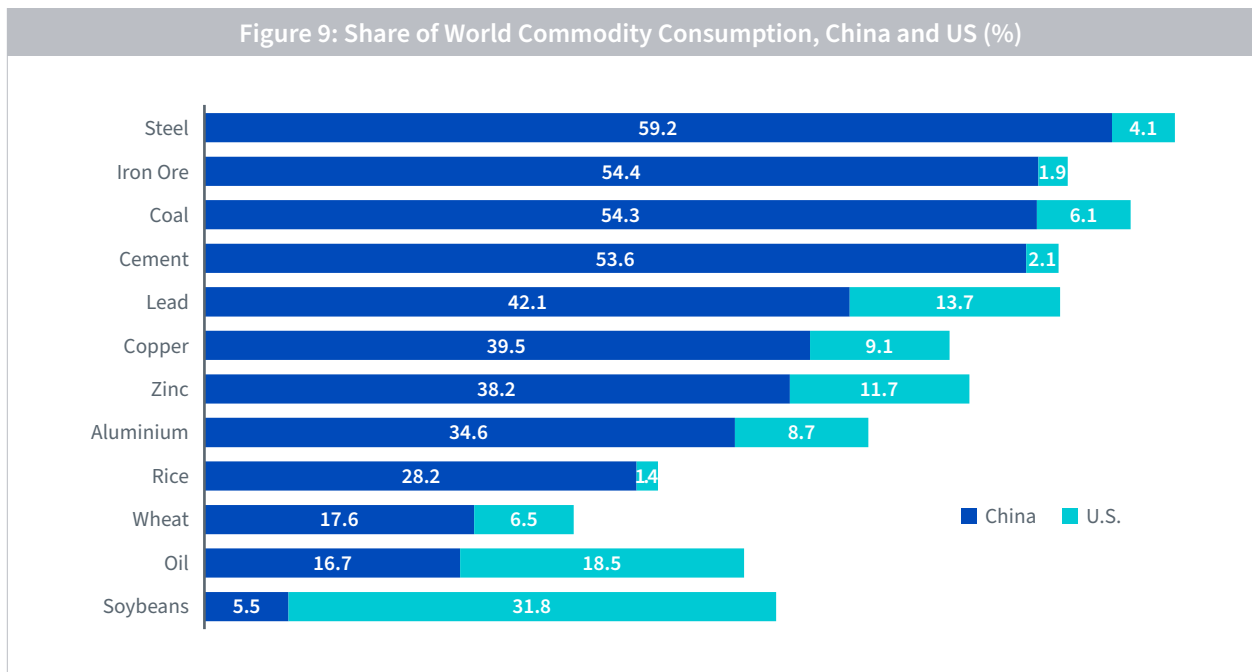
The 2022 playbook seems ripe for continuation in 2023: stick with defensives over cyclicals, be cautious of growth stocks and the formerly-hot COVID lockdown plays. It's a value market.

⁵ Source: Bureau of Labor Statistics, as of December 2022.

China Reopening: A Counterweight to Tougher Global Economic Conditions for Commodities

Commodities as a group rebounded strongly in 2021 and 2022, returning 27.3% and 14.7%, respectively, after suffering in 2020 (+2.3%) at the height of the COVID pandemic. The developed world reopening of trade in 2021 and 2022 was successful despite the absence of China’s participation.

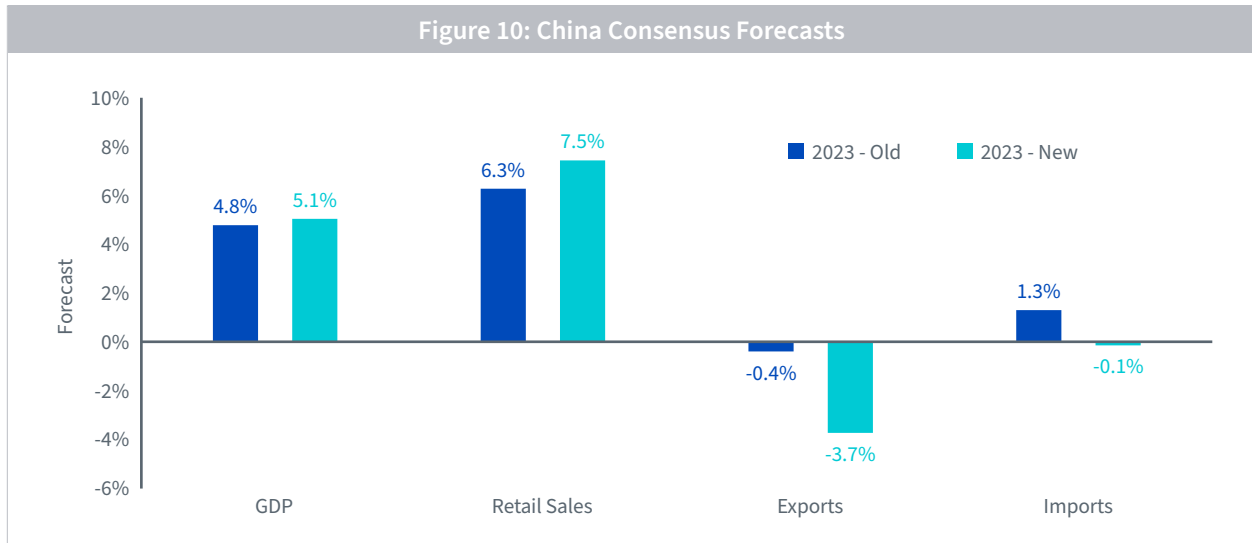
China, maintaining a Zero-COVID policy for several years, saw its domestic economy hamstrung and offered little support for the global recovery. China is the largest consumer of commodities (see figure 9). Now that China has reopened, commodities will receive a significant tailwind. From a global standpoint, commodities may face headwinds from developed world central banks tightening and threatening to tip their economies into recession, we are optimistic that the China reopening will act as a strong counterweight in this business cycle. Moreover, commodities are supported by a super-cycle in the form of an energy transition and infrastructure rebound (but that is a topic for another time). Here we focus on China.



Sources: United States Geological Survey, BP Statistical Review of World Energy, Food and Agriculture Organization of the United Nations, International Monetary Fund, United States Department of Agriculture, 31 December 2021. **Historical performance is not an indication of future performance and any investments may go down in value.**

MEASURED OPTIMISM

Since China dismantled its Zero-COVID policies, economists have revised forecasts for the country. GDP and retail sales have been revised upwards (figure 10). Clearly China-watchers are more optimistic about domestic conditions.

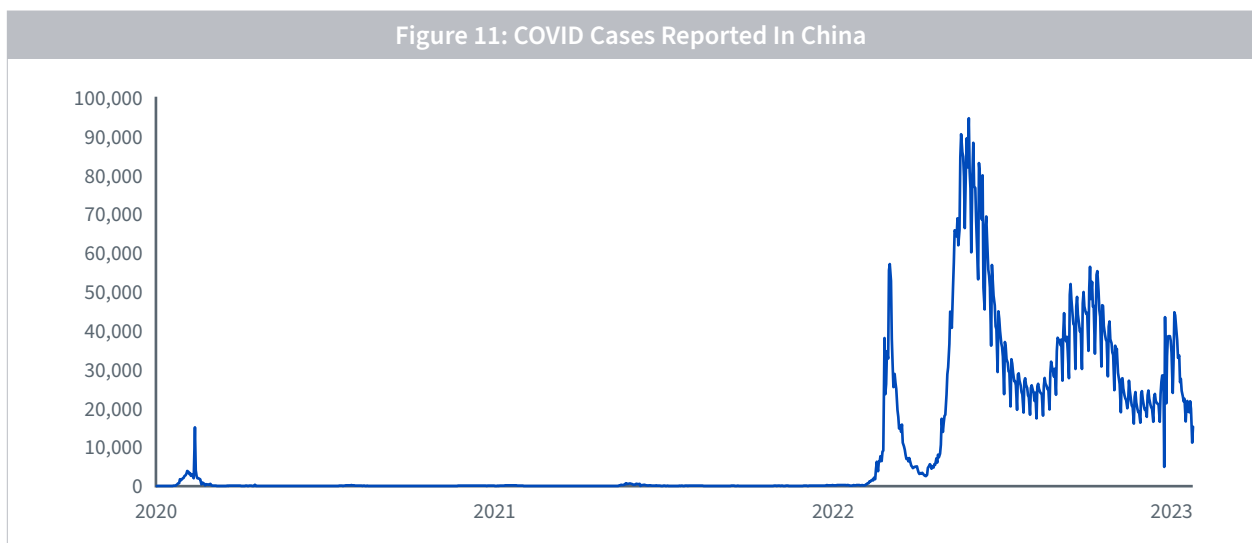


Source: Bloomberg Survey of 66 economists conducted from 12 January 2023 to 18 January 2023. **Historical performance is not an indication of future performance and any investments may go down in value.**

DATA FOG DURING LUNAR NEW YEAR PERIOD

It's hard to judge precisely how quickly activity is bouncing back or not, as data is usually lagged, and data reporting is also delayed in the New Year celebration period.

But if you take COVID cases reported to World Health Organization at face value, they look like they have peaked (although disruptions from still elevated cases may linger for longer).

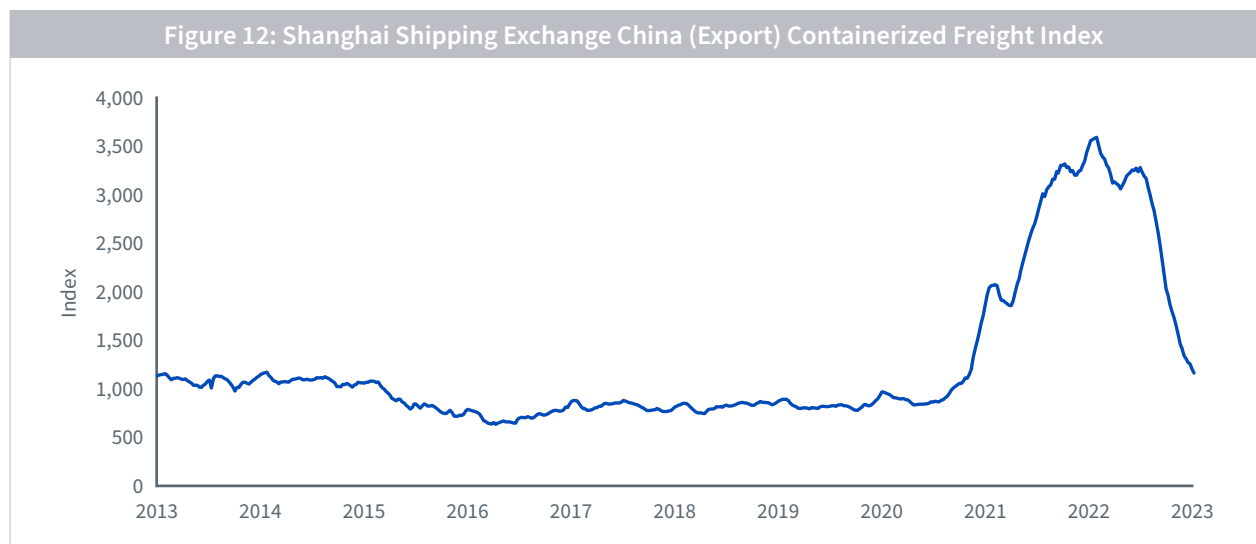


Source: World Health Organization, 25 January 2023. **Historical performance is not an indication of future performance and any investments may go down in value.**

CHINA’S OUTSIZED TRADE EXPOSURE COULD BE ITS ACHILLES’ HEEL

Consensus trade forecasts have been revised downwards, both in terms of imports and exports (figure 10). Weak international demand is weighing on China. Industry participants in China point to an increase in “blank sailings”, where carriers miss ports because there is not enough cargo to pick up or they fear delays. According to supply chain data provider Drewry, the rate is “exceptionally elevated” and they expect cancellation rates for ships travelling from Asia to Europe or the Pacific to rise to 31% over the coming weeks, up from 23% in the same period last year and 16% in 2021.⁶ The 2021–2022 period saw exceptional activity as the rest of the world boosted demand for Chinese goods exports (figure 12). That elevated scale of activity may be returning to normal and the question is, will China domestic demand make up for the shortfall from international demand?

The spike in COVID cases is likely contributing to delays, but many shipping companies, including Maersk and Cargill, expect this source of delay to abate.



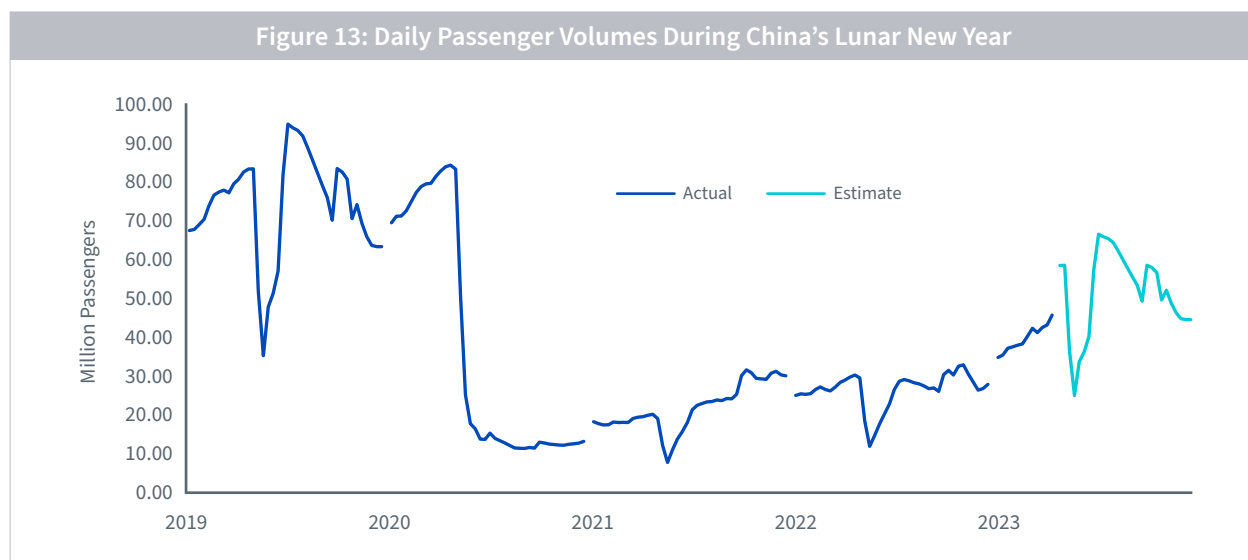
Source: Bloomberg, 20 January 2023. **Historical performance is not an indication of future performance and any investments may go down in value.**

DOMESTIC ENERGY DEMAND ON A RAPID REBUILD

Looking at domestic conditions, things are rapidly rebounding. China’s oil demand took a heavy hit in December as COVID infections surged after the government relaxed its restrictions. But the recovery in January has shown strong momentum. Passenger volumes for the annual Chunyun, a 40-day travel boom when people drive or fly home for family reunions, have rebounded to 50% of 2019 levels, a 30% increase from last year (figure 13). Subway ridership across major cities has rallied to 70% of pre-pandemic levels, almost doubling from December lows. Flight schedules have ramped up by nearly 30% in the past two weeks (to 19 January 2023), boosting jet fuel demand.

China is handing out generous import and export quotas to refiners to encourage more oil refining as the central regulators strive to boost the economy.

⁶ Source: Drewry, 26 January 2023.



Sources: BloombergNEF, Ministry of Transport, 19 January 2023. **Historical performance is not an indication of future performance and any investments may go down in value.**

According to BloombergNEF, China is on track to see a rebound in gas consumption growth as the abrupt ending of its Zero-COVID policy will accelerate economy recovery. Liquefied natural gas (LNG) imports are set to increase, which would allow China to overtake Japan again to become the top LNG importer globally in 2023.

METAL DEMAND IS HARDER TO ASCERTAIN

With a lack of high frequency data on metal demand, we are prone to fixate over the bearish realised demand numbers from China at the tail-end of 2022. However, we should remember that metal supply is very tight. With mining struggles in key producing countries like Chile and Peru, a collapse in smelting activity in Europe (due to the energy shock), and inventory of most base metals remaining very low across the major exchanges, China's soft demand prevented extreme tightness in metal markets. With China announcing reopening, widespread shorts in many metals have been covered, driving the first stage of a rally. If demand were to pick up visibly, we think long bets will help drive the next stage of a rally.

REAL ESTATE OVERHANG

Real estate and infrastructure are key sources of commodity demand. The real estate overhang discussed in the introduction may limit a rebound in demand. However, on 13 January 2023, policy makers produced a draft 21-point plan to provide liquidity to "good quality" developers⁷. It's unclear what makes a "good quality" developer, but the *The Economist* magazine reports that developers began raising new debts in December, indicating the policy easing started before the announcement was made official.

Expecting a full recovery in the real estate sector maybe ambitious, but the policy support may help avoid further decline in commodity demand from this sector.

CONCLUSIONS

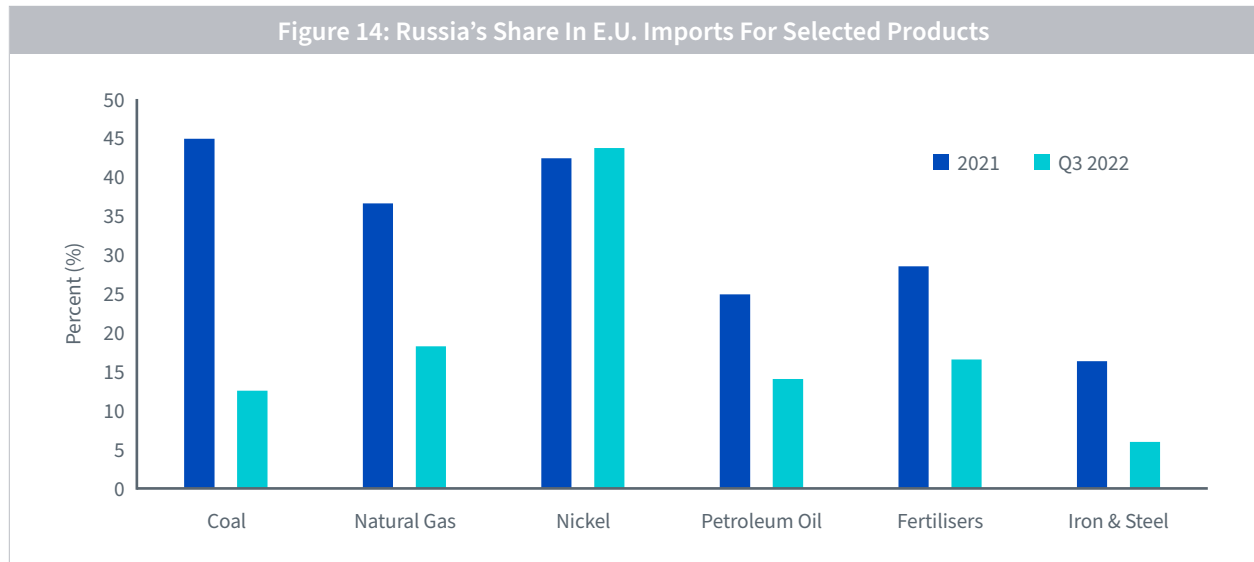
While China faces headwinds from international demand softness and a domestic real estate overhang, travel data looks encouraging and indicates a rebound in domestic activity. Energy demand is likely to be a beneficiary. As COVID cases subside, we expect delays in getting goods to ports to decline, although the strength of international demand may remain under question.

⁷ *The Economist*, 23 January 2023.

Europe is Back From the Brink

Europe has ushered in 2023 on a stronger economic footing. The confluence of the reopening of the Chinese economy, prudent management of energy storage during the winter and signs of peak inflation have helped the eurozone economy. So far, Europe has been successful in winning its energy war against Russia.

However, this energy war is similar to the one being fought on the ground between Russia and Ukraine and could continue for a long duration. This is why complacency is not an option for European policy makers. As we can't always rely on favourable weather, a continuation of measures—shoring up gas reserves and rationing of energy demand across industry and households—will need to continue as Europe weans itself from Russia's commodity supply.



Sources: Eurostat, WisdomTree as of 31 December 2022. **Historical performance is not an indication of future performance and any investments may go down in value.**

GREEN SHOOTS EMERGE FOR EUROZONE ECONOMY

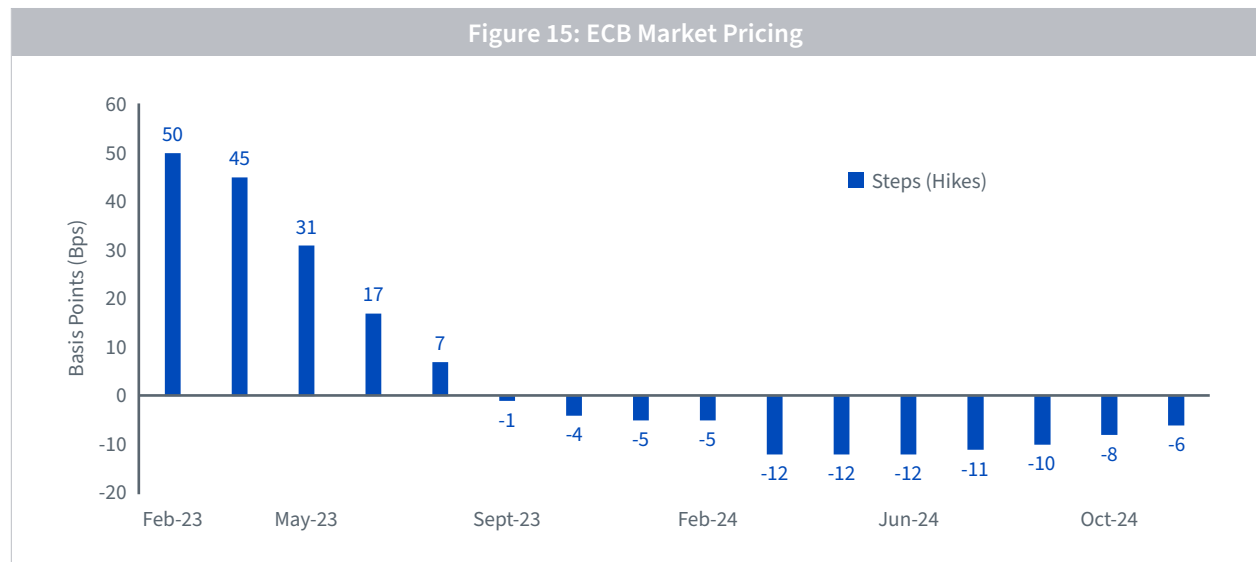
Most high frequency indicators seem to show that we are moving past the trough and while activity is improving it remains weak. Supply chain stress has eased, helping producers in Germany (Europe's largest economy). In fact, assuming that China's reopening fully materialises, Germany could see the largest GDP boost owing to the improved access to inputs from China. Employment growth also gathered momentum as firms prepare for a better-than-expected year. Euro-area consumer sentiment has recovered to levels last seen in May 2020. This is because the more benign impact of energy on inflation has reduced the income squeeze on consumers, companies and governments, supporting the case that a deep recession will be avoided by the eurozone.

EUROPEAN CENTRAL BANK (ECB) LIKELY TO DECOUPLE FROM THE FED

The decline in headline eurozone inflation was driven by a fall in prices due a large one-off subsidy in Germany. For this reason, inflation releases in H1 2023 are likely to be extremely volatile owing to a number of government measures and technical adjustments to the Harmonised Index of Consumer Prices (HICP). The annual adjustment in the HICP weights will increase the share of the energy component, thereby reflecting the relative rise in energy consumption in 2023, signaling upside risks to energy inflation. So, while energy inflation has begun to peak, there remains uncertainty as to how fast prices will fall. China’s reopening, alongside the domestic eurozone import ban of Russian oil, does remain an upside risk for oil prices.

Core inflation tends to have a high correlation with Purchasing Managers’ Index (PMI) margin pressure (backlogs less delivery times). After witnessing a sharp rise in PMI margin pressure, we now see signs for a sharp reversal which is likely to feed into core inflation with a lag of 12 to 18 months. However, with core inflation hovering around 5%, the ECB is unlikely to wait for the reversal to play out.

The ECB raised its key interest rates by 250 basis points (bps) over the course of 2022. President Lagarde has signalled this is far from the end of the road. Given the recent more resilient macro data, we expect the ECB to continue tightening policy until May, with a peak of 3% for the deposit rate. We expect the tightening of credit conditions to eventually slow down the economy with the usual time lag likely dampening the current European equity rally. We view restrictive monetary policy by the ECB alongside the stronger Euro as the main headwinds for European equities in 2023.

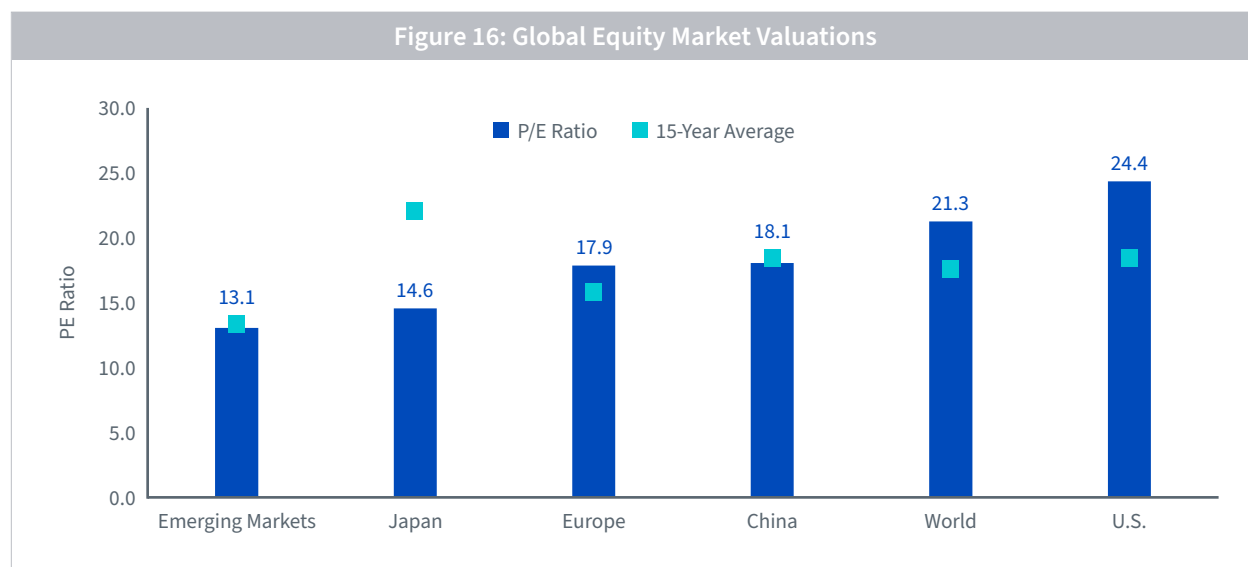


Sources: Bloomberg, WisdomTree, as of 31 January 2023. **Historical performance is not an indication of future performance and any investments may go down in value.**

UNWINDING OF THE ENERGY SHOCK & CHINA’S REOPENING BENEFIT EUROPEAN EQUITIES

European equities have staged a pronounced rally since October 2022, up more than 18%⁸. The improvement in hard data, China’s reopening and the benign impact of the energy crisis have enabled European equities to overshoot U.S. equities by 6.4%⁹. Europe tends to have a greater exposure to value. The outperformance of value-oriented equities within the energy, financials and healthcare sectors benefitted from the long-awaited rotation from growth into value.

Added to that, the reopening of the Chinese economy in December fuelled the rally further. This was evident from the outperformance of consumer goods, retailing and the semiconductor sector. The top five sectors in Europe by China revenue exposure are semiconductors, materials, consumer durables (luxury goods), energy and autos. At 8% of sales, Europe has the second-highest exposure after Asia-Pacific (ex-Japan) to China. We also know Chinese consumers saved one-third of their income last year, depositing 17.8 trillion yuan (\$2.6 trillion) into banks, and investors are pinning their hopes on those savings finding their way into Europe’s luxury good market.



Sources: Bloomberg, WisdomTree, as of 31 January 2023. **Historical performance is not an indication of future performance and any investments may go down in value.**

Europe’s energy sector accounted for two-thirds of Europe’s earnings per share (EPS) growth in 2022. The continuing trend of capital discipline and resilient earnings, alongside high shareholder returns, should keep attracting flows into the sector in 2023.

European valuations at a 17.9x P/E ratio reflect that equities have already priced in the China re-opening trade alongside its prudent energy management evident from the erosion of its 35% discount to its 15-year average, a month back. So, the European equity momentum should fade in the interim.

While China will play a critical factor in bolstering Europe’s growth in 2023, it’s important to bear in mind that European companies earn the twice the amount of revenue from the U.S. than from China. So, a soft landing in the U.S. will be vital for Europe to continue its cyclical rally. We view restrictive monetary policy by the ECB alongside the stronger euro as the main headwinds for European equities in 2023.

⁸ Source: Bloomberg, Performance of EuroStoxx 600 Index from 29 September 2022 to 31 January 2023.

⁹ Source: Bloomberg, Difference between performance of EuroStoxx 600 Index versus the S&P 500 Index from 29 September 2022 to 25 January 2023.

UK ECONOMY TO FACE THE HARSH REALITY OF A RECESSION IN 2023

For the UK economy, 2023 is set to be a challenging year. Forecasts for a drop in UK real GDP, ranging between 0.4% (the Confederation of British Industry estimate) and 1.4% (the Office for Budget Responsibility estimate), point to a shallow recession as inflation and higher interest rates take their toll on consumers and businesses. While the terms of trade shocks caused by the global energy markets begin to recede, constrictive financial conditions underpinned by the Bank of England's (BOE) restrictive policy remain a headwind for the UK economy.

RESILIENCE OF BUSINESS AND HOUSEHOLD INCOMES

Owing to the surge in inflation, 2022 saw the sharpest drop in household incomes on record. It's unlikely to start rising again until the second half of 2023. On the positive side, inflation has begun showing signs of easing. However inflation is likely to be structurally higher and stickier on the upside owing to higher wages and supply chains. The UK is faced with acute labour shortages, which is placing workers in a strong pay bargaining position. While nominal earnings will rise by around 7% this year, real incomes are likely to be sharply negative with inflation hovering well above at 10%.

The sharp fall in household disposable incomes will inevitably suppress consumer spending. Despite the fact that households have accumulated close of £250 in excess savings, the additional cost of higher interest rates, electricity and gas is likely to dip into their savings unless the UK government continues to shield households facing the cost-of-living crisis. One silver lining is the sharp fall in wholesale energy prices should help households' annualised energy bills to drop by around £2.6k in July from £3k in Q2 and trend lower over the upcoming quarters.

Business surveys remain consistent with job losses in H1 2023, as firms endeavour to reduce costs in the face of higher financing costs. Given that nearly 80%¹⁰ of corporate bank loans are floating rates, the increase in the bank rate would have raised their debt servicing costs.

IMPLICATIONS FOR THE BOE

We expect the BOE to raise the bank rate to 4% in February and hold that level for the rest of the year. Most of the slack in the economy should accumulate in the labour market, allowing a sustained slowdown in core inflation.

THE IMPACT OF CHINA'S REOPENING ON UK EQUITIES

Turning our attention back to UK equities, despite all the headwinds facing the UK economy, the benchmark FTSE 100 Index is uniquely positioned. The FTSE 100 index provides investors with a global exposure given the large number of international earnings constituents. While the weaker U.S. dollar might pose as a headwind, the reopening of the Chinese economy could benefit the index's commodity intensive producers and financial stocks. The FTSE 100 Index derives a 7% revenue exposure from China. While the outlook for the UK economy is mired by headwinds, valuations at just 10 times 12-month forward earnings compares favourably with global equity market valuations.

¹⁰ Source: Bloomberg, Difference between performance of EuroStoxx 600 Index versus the S&P 500 Index from 29 September 2022 to 25 January 2023.

Appendix

Glossary

Balance sheet: Refers to the cash and cash equivalents part of the current assets on a firm's balance sheet and cash available for purchasing new position. **Basis point (bp):** 1/100th of 1 percent. **Bureau of Economic Analysis (BEA):** A U.S. government agency that provides official macroeconomic and industry statistics, most notably reports about the gross domestic product (GDP) of the United States and its various units—states, cities/towns/townships/villages/counties, and metropolitan areas. **Central bank:** A national bank that provides financial and banking services for its country's government and commercial banking system, as well as implementing the government's monetary policy and issuing currency. **Commodity:** A raw material or primary agricultural product that can be bought and sold. **Confederation of British Industry:** A not-for-profit membership organization that speaks on behalf of 190,000 businesses. **Consumer confidence:** An economic indicator that measures the degree of optimism that consumers have regarding the overall state of a country's economy and their own financial situations. **Consumer Price Index (CPI):** A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living. Core CPI excludes food and energy costs. **Earnings growth:** The annual compound annual growth rate of earnings from investments. **Earnings per share (EPS):** Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation. **European Central Bank (ECB):** The prime component of the euro system and the European System of Central Banks as well as one of seven institutions of the European Union. **Federal Open Market Committee (FOMC):** The branch of the Federal Reserve Board that determines the direction of monetary policy. **Federal Reserve (Fed):** The Federal Reserve System is the central banking system of the U.S. **Gross domestic product (GDP):** The sum total of all goods and services produced across an economy. **Growth stocks:** Stocks whose share prices are higher relative to their earnings per share or dividends per share. Investors are willing to pay more because of their earnings or dividend growth expectations going forward. **Harmonised Index of Consumer Prices (HICP):** An indicator of inflation and price stability for the European Central Bank. **Inflation:** Characterized by rising price levels. **New York Fed General Business Survey:** The monthly survey of manufacturers in New York State conducted by the Federal Reserve Bank of New York. **Office for Budget Responsibility:** A non-departmental public body funded by the UK Treasury, that the UK government established to provide independent economic forecasts and independent analysis of the public finances. **Price-to-earnings (P/E) ratio:** Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per unit of money invested. **Recession:** Two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemployment. **St. Louis Fed's Blue Chip Survey of Professional Forecasters:** The oldest quarterly survey of macroeconomic forecasts in the United States. The survey began in 1968 and was conducted by the American Statistical Association and the National Bureau of Economic Research. The Federal Reserve Bank of Philadelphia took over the survey in 1990. **U.S. Treasury (UST):** A debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government. **Value:** Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Index Definitions

Conference Board Consumer Confidence Index: The monthly Consumer Confidence Survey®, based on a probability-design random sample, is conducted for The Conference Board by Nielsen, a leading global provider of information and analytics around what consumers buy and watch. The Conference Board is a global, independent business membership and research association working in the public interest. **FTSE 100 Index:** The Financial Times Stock Exchange 100 Index is a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalisation. **National Association of Homebuilders (NAHB) Housing Market index:** An index that rates the relative level of current and future single-family home sales. The data is compiled from a survey of around 900 home builders. A reading above 50 indicates a favorable outlook on home sales; below indicates a negative outlook. **Purchasing Managers' Index (PMI) (UK):** In the UK, a purchasing managers' index produced by a company like IHS Markit is an economic indicator representing the rate of expansion or contraction of a specific sector—such as manufacturing, services or construction. **Purchasing Managers' Index (PMI):** Represents the health of the manufacturing sector based on new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI above 50 signifies expansion while below 50 signifies contraction. (Also ISM Purchasing Managers' Index.) **S&P 500 Index:** A market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy. Investors cannot directly invest in an index.

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