Financial markets versus central banks: a different view?

The growth data for the last quarter of 2022 have confirmed the intense and expected slowdown in global economic activity caused by the effects of rising energy prices and tightening monetary policy. However, far from causing corrections in financial asset prices, this intense downward adjustment in the business cycle is coinciding with near double-digit gains in the stock markets since the beginning of the year and cumulative falls in long-term government debt yields of around 50 bps. This increased risk appetite comes as investors anticipate that we are now leaving behind the worst economic omens that were feared after last summer (global stagflation), as the imbalances between supply and demand gradually dissipate and the inflationary pressures are gradually corrected.

The bottom line is that, once domestic demand reflects the effects of the interest rate hikes, the hardest part of the central banks' work will have been largely completed. The problem is that the markets are already – perhaps precipitously – pricing in an imminent shift in monetary policy, relying on a rapid change of trend in the more cyclical components of the consumer price baskets. Furthermore, the easing of financial conditions caused by this risk-on movement does little to help the monetary authorities' efforts to combat inflation. At the moment, the central banks are trying to use their communication policy to rein in expectations of a pivot in interest rates, but with little success (as evidenced by the historic daily decline in yields in Europe following the latest 50-bp rate hike). The central banks' goal is to try to limit a rise in financial instability in the event of further upside surprises in prices.

This game between investors and central banks will determine the performance of financial assets in 2023, in an economic context still subject to high volatility and uncertainty. Above all, in addition to the already known risks (such as inflation, the war in Ukraine and China), there are new ones appearing on the horizon, such as the debt ceiling in the US and the effects that changes in Japan's monetary policy could have on Japanese investors' international bond holdings. It therefore seems premature to assume there will be a soft landing that will allow the central banks to quickly reduce interest rates and keep the trends we have seen in the financial markets in the opening weeks of the year on track.

The good news is that the favourable (and unexpected) wealth effect of the first few weeks of the year comes in addition to other encouraging signs, including the buoyancy that most labour markets continue to show (53-year lows in the unemployment rate in the US), the strength of private sector balance sheets (with households in the US and China still hoarding significant savings), the improvement in household and business expectations since November and, above all, the improvement in the energy outlook in recent months. All this is translating into a widespread upward revision in economic forecasts, when we all thought this winter could bring the exact opposite. In our case, we have increased our forecast for average growth in the euro area in 2023 from 0.2% to 0.5%, which implies improvements for countries as important as Germany (from –0.2% to 0%), Italy (from –0.2% to 0.5%) and Spain (from 1% to 1.3%). In doing so, we move away from the scenarios that would entail job destruction, although the forecasts will remain subject to a high degree of unpredictability, reflecting the fact that we are in a year of transition in which the conditions must be laid for a return to a certain normality beginning in 2024. Therefore, we change the forecasts, but not the narrative, as we will continue to face a highly complex scenario in the short term, with more questions than answers about the changes that the economic environment is facing. And while the improvement in investor sentiment should be taken as an encouraging sign, it will only be endorsed by a downward adjustment in inflation that extends to most of the components of the consumer basket – a development that will no doubt require time and patience.

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