MOODY'S ANALYTICS

WEEKLY MARKET OUTLOOK

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Lead Authors

Dante DeAntonio
Director

Matthew Walsh
Economist

Asia Pacific

Stefan Angrick
Senior Economist

Illiana Jain
Economist

Sarah Tan
Economist

Europe

Ross Cioffi
Economist

Olga Bychkova
Economist

U.S.

Steven Shields
Economist

Matt Orefice
Data Specialist

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Employment and Inflation Go the Fed's Way

Payroll employment was in line with our expectations in December, rising by 223,000, while the October and November figures were revised down by a combined 28,000. In total, there were 4.5 million jobs added in the U.S. in 2022—the second-highest annual total on record after 2021's 6.7 million job growth. The unemployment rate ticked lower to 3.5%, even as the labor force participation rate increased, thanks to household survey employment posting its largest gain since March.

There was meaningful progress made in the fight against elevated inflation in the final quarter of 2022. December's consumer price index slid 0.1% from the month before. Core CPI, which strips away food and energy, rose 0.3% from November to December. Relative to a year earlier, headline CPI was up 6.5%, its lowest annual rate since October 2021.

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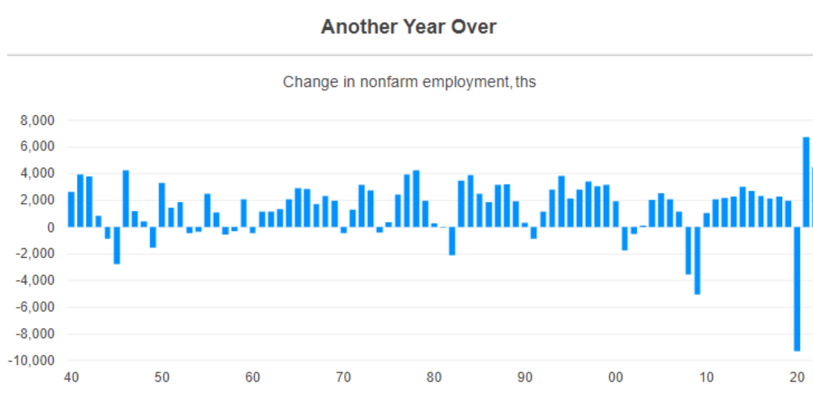


Plenty for the Fed to like on employment…

Though the Federal Open Market Committee's next meeting is still weeks away, December's jobs report is the last one that policymakers will see before they reconvene. Last week's labor market data were not expected to have a major impact on the FOMC's thinking, though there are details within the report that committee members will receive warmly.

At the beginning of 2022, monthly payroll growth was averaging about 600,000 jobs but decelerated steadily to finish the year averaging less than 250,000. An ultra-tight U.S. labor market has proven stubbornly resilient and fanned anxieties that elevated wage growth will force the Fed to implement ever more restrictive policy to bring inflation toward the central bank's target, increasing the likelihood of a policy mistake. While the pace of deceleration has been slower than expected, and given the Fed cover to continually raise rates, the slowdown in 2022 is a preferable alternative to a sharp downturn.

The most pain-free way for the Fed to feel better about inflation is for a sustained increase in labor supply. The labor force grew solidly in December, pulling the participation rate up from 62.2% to 62.3%. Carrying this trend through 2023 would result in more job seekers per open position, a way of reducing wage growth and limiting existing-income loss. The prime-age labor force participation rate ticked up similarly, from 82.3% to 82.4%.

While not our preferred measure of wage growth, given unaccounted-for compositional differences, average hourly earnings in December grew at their slowest rate since February on a month-to-month basis. The 4.6% annual increase in average hourly earnings is well above where the Fed would like to see wage growth, but December's data indicate a trend in the right direction. Average hourly earnings were up an annualized 4.1% in December, on a three-month moving average basis, while average weekly hours worked slid from 34.4 to 34.3.

The unemployment rate dropped to 3.5% in December, down from November's revised figure of 3.6% and still near 50-year lows. Projections released in December show the median FOMC committee member expected the unemployment rate to hold at 3.7% by year's end before steadily rising to 4.6% by the end of 2023. The latest Moody's Analytics baseline expects a slower loosening, with the unemployment rate only reaching 4.1% by the end of this year. Hope remains alive for the Federal Reserve if firms' diminishing appetite for labor manifests itself in less-painful ways, like reduced hours for existing staff, less temporary staffing, and the removal of open job postings.

…And inflation lends a hand as well

December's consumer price index delivered more good news, with the headline index falling 0.1% from the month before and core CPI rising 0.3%. The latest datapoint closes the books on 2022 and signals that meaningful progress in the U.S. economy's fight against elevated inflation was made in the closing months of the year. Using an annualized three-month moving average, the final quarter of 2022 saw core CPI rise 3.14%. This is the lowest figure since September 2021 and represents substantial progress from the 7.9% peak reached in June. However, this is still above the Fed's target, and we estimate U.S. households were spending $371 more per month in December than they were a year earlier.

Rental prices, after surging through most of 2022, have seen a fairly dramatic slowdown of late and will deliver downward pressure on services CPI later in 2023 as yearlong leases get renewed and come with more modest price increases than in the previous year. Our latest baseline forecast expects inflation to slow to 4% in 2023 and then 2.4% in 2024. The assumptions underpinning a steady deceleration in inflation are the U.S. economy growing below potential, declining global energy prices, slower rent price growth, and a moderation in wage growth. Should elevated inflation stick around longer than we expect, it likely will be due to persistently strong wage growth. Since rapid pay increases can perpetuate broader inflation, wage growth is the paramount concern of the Federal Reserve. Success for the Fed means a sustained deceleration in wage growth without a coinciding substantial increase in joblessness. It's a narrow path but not an impossible one.

December's CPI print is the only one between now and the rate-setting Federal Open Market Committee's next meeting that ends in early February. Futures markets and our latest baseline expect a 25-basis point increase to the fed funds rate target range to be announced then. This would mark consecutive slowdowns after December's FOMC meeting resulted in a 50-basis point rate hike. Fed officials are signaling that a slowdown is needed to allow earlier cuts to flow through the economy. We expect a pause in rate hikes to occur later this year and have pushed back the first expected rate cut into 2024 instead of the fourth quarter of 2023.

TOP OF MIND

Prices Fall, but Housing Remains Overvalued

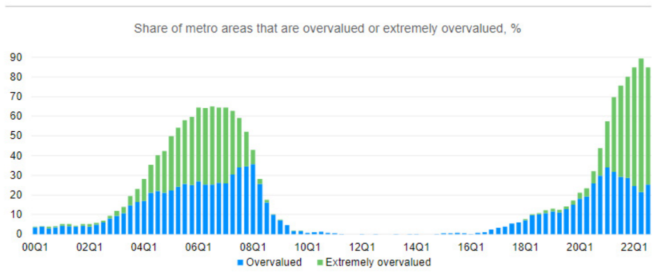
BY MATTHEW WALSH

The summer months brought an end to housing's meteoric rise, and the market has since entered recession. U.S. house prices peaked in July and have since come down about 1.5%, according to the Moody's Analytics Home Price Index. Nevertheless, national house prices remain extremely overvalued, exceeding their long-run equilibrium price by more than 23%. While this is markedly below the record high set last spring, houses remain more overvalued than during the height of the 2000s housing bubble.

Frenzied homebuying juiced by ultra-low mortgage rates and shifting preferences during the COVID-19 pandemic are keeping markets overvalued despite the recent drop in sales and prices. Prices have retreated only to their April level and are still almost 40% higher than at the start of the pandemic, compared with a 14% rise in our estimate of fundamental value.

Moody's Analytics estimates overvaluation by comparing the Moody's Analytics Home Price Index for a given geography to its long-run equilibrium home value. This equilibrium home value, or fundamental value, is determined by estimating the long-run statistical relationship between house prices and per capita wage and salary income. House prices that exceed their fundamental value by more than 10% are considered overvalued and those that are more than 20% higher are considered extremely overvalued.

Fewer Markets Are Extremely Overvalued



Source: Moody's Analytics

Nearly 60% of U.S. metro areas are extremely overvalued, which is a slightly smaller share than in the second quarter as house prices decline. There were more overvalued markets in the third quarter; however, this is because of house prices in once extremely overvalued markets, falling closer to their fundamental prices. Still, as testament to the astonishing rise and geographic breath of price appreciation, only 10 metro areas are undervalued even with three months of declines in national house prices.

Of the largest U.S. metro areas, the five most overvalued have not changed much from the prior quarter. Boise City ID remains the most overvalued market in the U.S., with the current price of homes exceeding the long-run equilibrium by 72%.

Boise has been one of the largest benefactors of the rise in remote work. In-migration soared over the past two years as residents flee high-cost urban areas, now that they are no longer tied to offices. The quick increase in population only added to the upward pressure on prices caused by low interest rates and a limited stock of homes. As a result, house prices surged by nearly 55% from the start of 2020. House prices peaked in Boise, but strong prior gains are keeping home valuations sky-high.

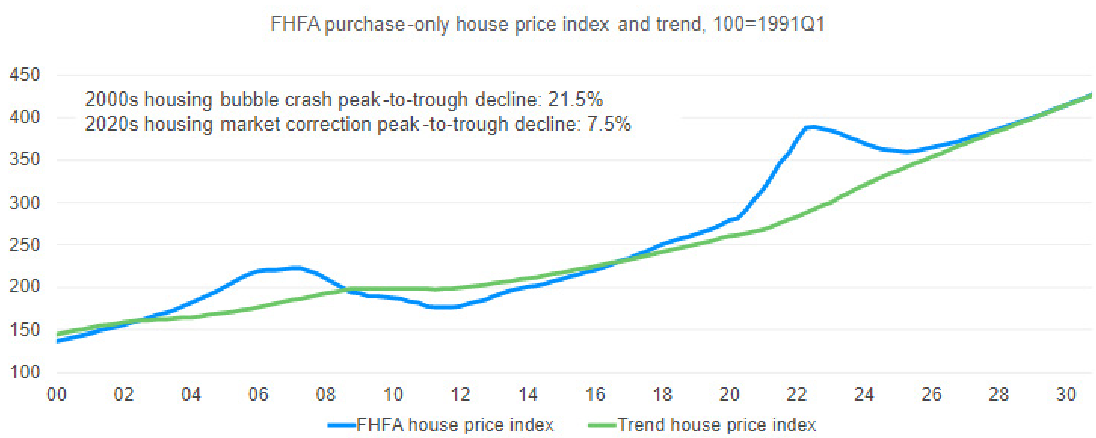
Across most large metro areas, overvaluation peaked with house prices. The cooling housing market is allowing economic fundamentals to catch up to prices in 85 of the 95 metro areas with more than 750,000 residents. Further, there are an increasing number of undervalued large metro areas. These are areas where house prices were largely in line with their economic fundamentals and had house prices decline as mortgage rates rise.

San Francisco is the most undervalued housing market and prices have fallen by more than 5% from their May peak, according to the Moody's Analytics Home Price Index. The metro division is quickly bleeding residents and is contending with the worst tech layoffs since the bursting of the dot-com bubble. Nevertheless, with homes now undervalued, price declines will cease and the FHFA purchase-only forecast expects prices to flatline over the next two years. Regions with undervalued housing have greater upward pressure on prices due to a combination of reduced listings plus opportunistic purchases of homes, often for use in the rental market.

Nationally, the overvaluation index still points to a dire warning for the housing market: More declines are on the way. The FHFA purchase-only index posted a small increase in prices in October, and the pace of decline in the Case-Shiller index and Moody's Analytics HPI, which capture the entire housing market rather than government-backed loans, slowed. House price data are noisy and these monthly hiccups in prices are typical as supply and demand adjust. However, with housing still extremely overvalued, weakening demand will pull prices back to their fundamental value over the next two years.

Our baseline forecast expects that house prices will decline by 5% to 10% over the next two years. While a 10% decline in house prices is significant, the incoming correction will be a far cry from the crash that followed the 2000s housing bubble. Two years of record appreciation caused housing wealth to soar by $11 trillion. By 2025, house prices will be back to their late-2021 level, eliminating an estimated $4 trillion in housing wealth.

House Prices Fall Nationally, but Avoid Crash



Sources: FHFA, Moody's Analytics

The Week Ahead in the Global Economy

U.S.

The U.S. economic calendar picks up as we get the first readings on some January data. The NY Empire State Manufacturing Survey and the Philadelphia Fed Survey for January will provide critical insight into the direction of manufacturing in the new year. We also get the final wave of housing data for December, and we expect housing starts and existing-home sales to remain weak.

We will also continue to pay close attention to initial jobless claims as the timeliest indicator of changes in the labor market. Claims fell in the most recent data to the lowest point in several months and remain well below our estimate of the break-even level, or that consistent with no monthly job growth. While weaker hiring will certainly play a role in the future path of the labor market, it is hard to imagine a significant deterioration occurring without a meaningful uptick in layoffs and unemployment insurance claims.

Other key data to be released next week include the producer price index, retail sales, industrial production, and business inventories.

Europe

The calendar for the week ahead is filled with December inflation figures. We expect that the final releases in the euro zone will each confirm preliminary estimates published previously. As such, the euro zone's HICP inflation rate will likely decelerate to 9.2% year on year in December from 10.1% in November. Declines in energy prices will be the major cause, while core and food inflation will inch higher. We believe inflation has passed its peak, but it will take a long time still before inflation falls back to target.

Inflation in the U.K. meanwhile likely eased to 10.2% year over year in December from 10.7% in November. Energy inflation will also likely decline, thanks to lower gasoline and oil prices, but electricity and gas prices will be fixed, and will not benefit from lower wholesale prices until the price cap is recalculated in 2023.

The U.K.'s labour market likely was stable in the three months to November, with an unemployment rate unchanged from the October quarter at 3.7%. That said, we see recession forces pushing unemployment higher in the U.K. Likewise, we forecast a 0.2% month-on-month increase in retail sales after a 0.4% decline in sales in November. Despite the rebound the retail trend looking ahead is also negative, and we expect to see private consumption contract in both the fourth and first quarters.

Asia Pacific

Our baseline view is for the Bank of Japan to keep major policy levers unchanged. December's surprise tweak proves that Governor Kuroda can be counted on to pull a rabbit out of his hat, so further adjustments can't be ruled out. But the economic context is still weak with little demand-driven price pressure and output below pre-pandemic levels. A positive outcome in spring wage negotiations could crack open the door for monetary policy change, but sustained demand pressure requires more than a single year of robust wage gains.

Next week will also see a slew of data from China including GDP. We expect GDP to decline 1.1% year over year in the December quarter. COVID-19 restrictions have hampered growth throughout the year with consumers unable to spend as lavishly during lockdowns and manufacturing plants operating suboptimally. Some support was seen in the latter part of the year with large infrastructure spending announced and easing in restrictions. However, this is unlikely to have reversed much of the decline.

Geopolitical Calendar

Date	Country	Event	Economic Importance	Financial Market Risk
18-Jan	Japan	Bank of Japan monetary policy announcement	Medium	Low
7-Feb	Australia	Reserve Bank of Australia monetary policy announcement	Medium	Low
8-Feb	India	Reserve Bank of India monetary policy announcement	Medium	Low
March	Beijing	National People's Congress	High	Medium
7-Mar	Australia	Reserve Bank of Australia monetary policy announcement	Medium	Low
23-24-Mar	European Union	European Council summit	Low	Low
10-Mar	Japan	Bank of Japan monetary policy announcement	Medium	Low
2-Apr	Finland	General election	Medium	Low
4-Apr	Australia	Reserve Bank of Australia monetary policy announcement	Medium	Low
28-Apr	Japan	Bank of Japan monetary policy announcement	Medium	Low
April	Solomon Islands	General election	Low	Low
May	Thailand	General election	Low	Low
29-30-Jun	European Union	European Council summit	Low	Low

The Economy Remains Vulnerable to Recession

BY STEVEN SHIELDS

CREDIT SPREADS

Corporate credit spreads tightened to begin the new year. Many financial market stress indicators, including the Chicago Fed's National Financial Conditions Index, have approached neutral territory after peaking early in the fourth quarter. The ICE BofA US high yield index option-adjusted bond spread narrowed 32 basis points to 430 basis points in the past week. The spread has now narrowed 120-basis points from its high recorded at the end of September. The high-yield option adjusted bond spreads approximate what is suggested by the accompanying long-term Baa industrial company bond yield spread.

All told, high-yield spreads remain well below the 1,000-basis point spread indicative of a distressed bond market and corporate default rates. One factor limiting the widening in high-yield corporate bond spreads has been robust corporate earnings growth. Profits as a share of GDP have hovered at record levels since early 2020, with the incoming cash flow improving leverage ratios.

DEFAULTS

Five Moody's Investors Service-rated corporate issuers defaulted in November, down from the upwardly revised 10 defaults in October. The trailing 12-month global speculative grade corporate default rate was 2.6% as of the end of November, unchanged from the upwardly revised level in October. The building and construction sector and the retail sector each accounted for two defaults. The November defaults included two Chinese property developers: CIFI Holdings Co. Ltd and Greenland Holding Group Co. Limited, amid a record number of defaults in the sector. While Chinese policymakers recently rolled out a series of steps to support the property market, we expect these measures to boost near-term property demand only modestly.

The year-to-date global default tally through November stands at 82, compared with 55 defaults for full-year 2021. The construction sector accounts for the most defaults, with 21, all from China. Banking follows with 10 (eight from Ukraine, one from Poland and one from Angola). By region, North America has 33 defaults (30 in the US and three in Canada). The rest are from Europe (24), Asia-Pacific (21), Latin America (three) and Africa (one).

Under the baseline forecast, Moody's Credit Transition Model predicts that the default rate will rise to 2.9% at the end of 2022 and will climb to 4.9% by November 2023. The 4.9% rate, if realized, would exceed the historical average of 4.1%.

In the leveraged loan market, two Moody's-rated corporate issuers defaulted on loans in November: Vericast Corp. and Neovia Logistics LP. The issuer-weighted U.S. loan default rate held steady at 1.8% from October to November. The global high-yield bond default rate was 0.9% in November when measured on a dollar-volume basis, unchanged from the level at the end of October. Across regions, the comparable rate held steady at 1.0% in the U.S. and 0.5% in Europe.

U.S. CORPORATE BOND ISSUANCE

First-quarter 2020's worldwide offerings of corporate bonds revealed annual advances of 14% for IG and 19% for high-yield, wherein US$-denominated offerings increased 45% for IG and grew 12% for high yield.

Second-quarter 2020's worldwide offerings of corporate bonds revealed annual surges of 69% for IG and 32% for high-yield, wherein US$-denominated offerings increased 142% for IG and grew 45% for high yield.

Third-quarter 2020's worldwide offerings of corporate bonds revealed an annual decline of 6% for IG and an annual advance of 44% for high-yield, wherein US$-denominated offerings increased 12% for IG and soared upward 56% for high yield.

Fourth-quarter 2020's worldwide offerings of corporate bonds revealed an annual decline of 3% for IG and an annual advance of 8% for high-yield, wherein US$-denominated offerings increased 16% for IG and 11% for high yield.

First-quarter 2021's worldwide offerings of corporate bonds revealed an annual decline of 4% for IG and an annual advance of 57% for high-yield, wherein US$-denominated offerings sank 9% for IG and advanced 64% for high yield.

Issuance weakened in the second quarter of 2021 as worldwide offerings of corporate bonds revealed a year-over-year decline of 35% for investment grade. High-yield issuance faired noticeably better in the second quarter.

Issuance softened in the third quarter of 2021 as worldwide offerings of corporate bonds revealed a year-over-year decline of 5% for investment grade. U.S. denominated corporate bond issuance also fell, dropping 16% on a year-ago basis. High-yield issuance faired noticeably better in the third quarter.

Fourth-quarter 2021's worldwide offerings of corporate bonds fell 9.4% for investment grade. High-yield US$ denominated high-yield corporate bond issuance fell from $133 billion in the third quarter to $92 billion in the final three months of 2021. December was a disappointment for high-yield corporate bond issuance, since it was 33% below its prior five-year average for the month.

In the first quarter of 2022, worldwide offerings of investment grade corporate bonds totaled $901 billion, up 12% on a year-ago basis.

In the second quarter, corporate bond issuance weakened. Worldwide offerings of investment grade corporate bonds totaled $548 billion, down 21% on a year-ago basis. US$ denominated high-yield corporate bond issuance was $38 billion in the second quarter, down from $63 billion in the first three months of the year.

Third-quarter issuance declined further as higher interest rates weighed on lending activity. Worldwide offerings of investment grade corporate bonds totaled $505 billion, down 30% year over year. US$ denominated high-yield corporate bond issuance clocked in at $21 billion in the third quarter. High-yield issuance declined approximately 84% on a year-ago basis

Corporate debt issuance remained suppressed in the fourth quarter of 2022. US$-denominated high-yield issuance ended the year at $2.47 billion, reflecting a drastic 77% decline from 2021. Meanwhile investment-grade bond issuance totaled $1.29 trillion in 2022, a 20.8% decline from 2021. Over the past 12 months total US$-denominated issuance has tracked at a near-decade low.

There was $2.75 billion in US$-denominated high-yield debt issued in the first week of the 2023. Investment-grade bond issuance totaled $61.01 billion last week. Moody's expects issuance volumes will be driven by some return to refinancing activity in 2023, but this will be limited, especially in the first half of the year because of relatively low levels of maturing debt. However, the maturity wall is higher for 2024 and we expect most companies to address these maturities a year in advance.

U.S. ECONOMIC OUTLOOK

We made minor adjustments to the U.S. baseline forecast in January, as new data and tweaks to our monetary policy adjustments altered the outlook slightly. Fundamentally, the outlook remains the same. Given the Federal Reserve's rhetoric, we pushed the first cut in the federal funds rate back one meeting into 2024. Its aggressive increases are taking a toll on housing markets though perhaps less than desired on labor markets. The economy remains vulnerable to falling into recession this year, an increasingly widespread expectation judging by various surveys of economic forecasters and other commentators. Views on the timing and severity of a possible downturn vary considerably, although in general the consensus holds that if it were to happen, it would be mild.

Fiscal assumptions

Federal government spending added 0.2 percentage point to annualized real GDP growth in the third quarter. This was the first positive contribution from federal spending last year after subtracting 0.4 and 0.2 percentage point from growth in the first and second quarters, respectively. An alleviation in cost pressures for the Pentagon and a rebound in nominal nondefense expenditures supported real federal spending in the third quarter.

The U.S. Treasury budget deficit will shrink from 5.5% of GDP in fiscal 2022 to 4.2% in fiscal 2023 and 2024. However, federal fiscal conditions will deteriorate over the next decade. An aging population will apply upward pressure on entitlement spending, while higher interest rates and a larger debt load will boost net outlays for interest. The Congressional Budget Office estimates that net interest payments will exceed defense spending in fiscal 2029. Consequently, the Treasury budget shortfall will increase to 5.7% of GDP by fiscal 2032. Meanwhile, the debt-to-GDP ratio will rise from 97% in fiscal 2022 to 112% in fiscal 2032. Longer term, lawmakers will pass a medley of entitlement, tax and immigration reform to put the federal budget on a sustainable trajectory.

Despite the significant buildup of federal debt during the pandemic, lawmakers will not pass budget cuts as they did after the Great Recession. While fiscal austerity may not be as much of a risk, a divided Congress will not enact any economic support if the economy falls into a recession in 2023.

Energy price forecast and assumptions

Moody's Analytics has revised its oil and gas price forecasts through 2024. The most significant changes to the oil price forecast occur in the first half of 2023. Preparation for the European Union sanctions that took effect in December has mitigated the fallout on oil prices and created relief selling. This is because many major oil importers secured their oil supplies ahead of time to ensure the implementation of sanctions did not disrupt their economies.

In the past month, weak demand has also led to substantial oil price erosion. U.S. oil demand is 7% lower than it was a year earlier. This is demand destruction resulting from the cumulative effect of high oil prices. Warm weather is another reason for weak demand; Northern Hemisphere heating degrees through this point in the winter are among the lowest of the past 20 seasons.

Our natural gas price forecast has been reduced from $7 per million BTUs to $6.25 in the first half of 2023. We view the recent collapse as weather-driven and temporary. Liquefied natural gas contract prices are still much higher than current Henry Hub prices. However, arbitrage opportunities are unavailable because the Freeport LNG hub is still off line, German gas inventory is essentially maxed, and there is a lack of infrastructure to receive more U.S. cargo. Germany recently did welcome the first LNG carrier at its new Wilhelmshaven terminal, which portends the capability of the EU to quickly replace Russian trade with greater trans-Atlantic ties.

Minor changes to GDP growth

U.S. GDP rose 3.2% in the third quarter, according to the Bureau of Economic Analysis' third estimate, more than reversing the declines over the prior two quarters. Trade was a major, if temporary, support to growth, with consumer spending, business investment and government spending also contributing. Inventories and housing investment were major drags on growth.

Revisions to the baseline forecast for real GDP growth are modest. The forecast for real GDP now shows nearly steady growth in the final quarter of 2022 but much less growth in the first quarter of 2023. Annual growth in 2022 and 2023 is 2.1% and 1.3%, respectively, modestly higher than last month, mostly because of the stronger fourth quarter of last year. Growth in 2024 was revised up slightly to 2.1%, and growth in 2025 was unchanged at 2.7%. Both figures still suggest an economy returning to near-potential growth.

Business investment and housing

Business investment decelerated substantially in the first half of 2022 amid the tightening by the Fed and the uncertainties caused by the Russian invasion of Ukraine. However, since then, the pace has been more buoyant than expected. Revised BEA data show that total real capital spending in the third quarter rose 6.2% annualized, compared with the initial published figures of 3.7% in the advance estimate and 5.1% in the second release. Further, after jumping in August, nondefense capital goods shipments adjusted for inflation continued to rise through November and are now back to their highest point since May 2019.

On balance, the outlook for total real business investment is little changed from the December forecast. Real investment will rise by 5.2% on an annual average basis in 2023, with equipment spending rising by 4.7%. Structures will finally begin to rebound, but spending will remain well below what it was back in 2019 for a long time.

House prices are expected to continue their recent decline, falling 10% from peak to trough nationally and as much as 20% in some markets. While applications for construction permits and housing starts will remain depressed, building activity will continue throughout the year, given the large number of housing units that remain under construction because of supply-chain bottlenecks. The delivery of additional multifamily properties will place downward pressure on rents and help address the nation's housing deficit.

Labor market

The labor market remains resilient but is slowly moderating. Payroll employment was in line with our expectations in December, rising by 223,000, while the October and November figures were revised modestly lower. The average gain for the past three months of 247,000 shows a downward trend. The average for the prior three months was 366,000.

Our forecast is for the unemployment rate to rise steadily this year after averaging 3.6% in the fourth quarter. The unemployment rate will average 4.1% in the final three months of 2023, slightly lower than the 4.2% in the December forecast and just below the 50-basis point increase that has coincided with every recession. The unemployment rate will fall slightly in 2024, averaging 3.9% in the fourth quarter, identical to that in the December baseline.

We assume a full-employment economy is one with approximately a 3.5% unemployment rate, around a 62.5% labor force participation rate, and a prime-age employment-to-population ratio a little north of 80%. Demographic headwinds have kept the overall participation rate below that threshold. However, with the other two conditions met and nominal wage growth still running near 5%, it is safe to say the economy is at full employment.

Monetary policy

Interest rates will continue to rise in early 2023 as the Federal Reserve remains committed to its fight against inflation. However, policymakers slowed the pace of hiking to 50 basis points at the Federal Open Market Committee's December meeting, raising the target range for the federal funds rate to 425-450 basis points. The slowdown follows signals that inflation is moderating, most notably evidenced by two consecutive better-than-expected CPI reports in November and December.

Our assumptions for the policy rate in the January outlook are similar to the previous baseline. Like in December, we expect 25-basis point increases to the feds fund rate at the January and March FOMC meetings. Therefore, our terminal fed funds rate projection in 2023 still falls just shy of 5%.

We expect the Fed to keep rates at this level before cutting them at the first FOMC meeting in 2024. This is a slightly more contractionary outlook than in the previous baseline, which had the first cut at the December meeting this year. Monetary policy will remain restrictive through the end of 2025, when the fed funds rate returns to its neutral rate.

The baseline outlook reflects our expectation that inflationary pressures from supply-side frictions, energy markets, shelter, and U.S. labor market conditions will continue to soften throughout the year. The path for the Fed remains narrow: Policymakers cannot ease up too early and have repeatedly pointed to tight financial market conditions as the central monetary policy mechanism to dampen demand. Hawkish rhetoric at the December meeting reflected this concern; however, as U.S. demand is showing signs of sustained cooling, keeping interest rates too high for too long risks choking off the expansion and pushing up unemployment.

Inflation, thus, remains the key to the baseline outlook. The January vintage has the CPI rising 8% in 2022, 4% in 2023, and 2.4% in 2024, a rounding difference down from the prior baseline. The assumptions around moderating inflation have not changed and include a reduction in U.S. supply-chain stress, below-potential GDP growth, declines in global energy prices, and moderating nominal wage growth.

Euro Stocks Benefit From Slower Inflation

BY ROSS CIOFFI

Declining inflation readings in the euro zone, the U.K., and the U.S. are driving hopes for a dovish pivot among central banks. While monetary policy authorities will shift into lower gear compared to the autumn, we expect that they will continue hiking interest rates in the first half of 2023. In the meantime, assets have been benefitting from a better inflation outlook.

At the time of writing Thursday, the major European stock indexes are each up on the previous day, week and month. The U.K.'s FTSE 100 has risen above its year-ago levels, and over the past few weeks, it has recovered beyond pre-pandemic levels. This performance is despite inflation in the U.K. proving to be persistent, with the year-over-year rate down to just 10.7% as of November from 11.1% in October. Another decline in December is expected, but the U.K.'s year-over-year inflation rate will likely remain above the euro zone's 9.2% and the U.S.'s 6.5% inflation rates.

The Euro Stoxx 50, meanwhile, recovered past its pre-pandemic level in November and has risen to February 2022 pre-invasion levels. Bonds are struggling more than equities, with yields on the German and U.K. 10-year notes coming down from their heights in early December. However, yields are still significantly higher than they were a year earlier.

Even if inflation has passed its peak in the major economies, it is still significantly above target and damaging to consumers and businesses. Declines in natural gas prices continue to surprise, but these are multiples of what they were prior to the pandemic. In light of these factors, we have updated our January baseline forecast to include two more 50-basis point rate hikes by the European Central Bank at the February and March meetings. Another hike in spring will bring the terminal rate to 3.75%. Meanwhile, we expect the Bank of England to also continue hiking, with a terminal rate of 4.5% by the summer.

Ultimately, the good news out of stock markets in recent weeks does not change our view of the broader economy. We see considerable downside risks stemming from still-high inflation. Rising interest rates, meanwhile, will further weigh on disposable incomes as interest payments become heavier.

Italy retail bounces back

Retail sales in Italy rebounded by 0.8% month over month in November, recovering from a 0.3% decline in October. Sales of food and nonfood items increased over the month. Italian consumers have been resilient recently, as the following month either matches or shows an increase after a contraction in sales. However, downside risks are strong, and with high inflation and low consumer confidence, we expect households to pull back on spending in the fourth and first quarters.

Fortunately, there are some supports. Inflation most likely peaked in October. Households benefitted from lower petrol prices in November, and the Italian government has signalled that it foresees a cut in consumer electricity costs in 2023, thanks to the easing of natural gas prices. Unemployment remains at lows not seen in a decade, excluding the first months of the pandemic. Job security will keep a floor beneath spending.

However, we forecast a net contraction in private consumption, an important factor pushing the country into a modest recession this winter. Inflation has peaked, but it is still significantly above target. Electricity prices may be cut in 2023, but they will be at a level that is still substantially above the pre-pandemic norm. Although unemployment is low, wages are not keeping up with inflation, and rising interest rates are cutting further into disposable income.

Spanish industry falls again

Spain's industrial output fell by 0.7% month over month in November, marking the third consecutive month of declines. Manufacturers are struggling under the weight of input shortages, rising production costs, and faltering demand. These supply and demand issues are reflected in recent PMI surveys out of Spain's manufacturing sector. The indicator has been recovering during the past three months but is still deeply in contractionary territory. As of December, the indicator rose to 46.4 from 45.7, with survey respondents reporting falling output, decreased orders, and rising input costs. We foresee further declines in industrial production heading into 2023.

China's Oil Imports From Russia: A Blend of Sweet and Sour

BY SARAH TAN

China imports various grades of crude oil from Russia. Its main import blend is exported to China through the East Siberia-Pacific Ocean and Atasu-Alashankou pipelines and via seaborne shipments from the Russian Far East port of Kozminois. ESPO oil is listed as a light sweet crude type in the Platts Periodic Table of Oil, and Urals, a medium sour grade. Because of pipeline connectivity, ESPO is China's favourite crude oil grade, and independent refineries clustered in the eastern province of Shandong benefit from lower freight costs with its close shipping distance. Conversely, Urals crude, similar in grade to Middle Eastern crude oil, is only exported by seaborne shipment with a delivery time of up to two months from Russia's Novorossiysk Black Sea port.

China has been purchasing its favourite ESPO blend above the G-7 price cap, which has been in effect since 5 December. This effectively means that the G-7 price cap is not fully binding. Chinese refineries and Russian exporters have found ways to trade ESPO without relying on insurance and logistic companies from the West, such as using Russian tankers and insurers.

Urals crude is the preferred grade for European refineries because of its short trading cycle, low freight costs, and attractive yields. Before the embargo on seaborne exports was imposed by the EU, Russia dangled a carrot to find a home for its Urals crude once destined for the European markets. China readily scooped up Urals at a record discount. The discount aims to cover the higher freight costs in a bid to compete against similar crude grades traditionally imported from the Middle East. Off the back of these discounts, Urals has been trading below the G-7 price cap.

Urals is now rerouted to the east, as China and India are now the biggest consumers to take advantage of the discounts. China had been importing cautiously as strict COVID-19 pandemic measures had disrupted its economic activities throughout 2022, but as the country gears up for an economic rebound, now might be an opportune time for China to increase its Urals imports.

Elsewhere, India's appetite for Urals swelled in the face of lofty discounts. From importing a negligible volume of Russian crude prior to 2022, Russia became India's top oil supplier at year's end. As major buyers of seaborne Urals, both China and India could negotiate even steeper discounts. While it remains uncertain whether both countries are willing and able to absorb all the lost European Urals, the diversion to the east is gaining momentum.

The prospects of Russia's crude oil exports are now in the hands of China's and India's refineries. As China regains its footing in its battle against COVID-19 and resumes its course to recovery, the country's demand for oil will strengthen. Coupled with attractive discounts for Russian crude, an increase in imports of both the ESPO blend and Urals crude is on the horizon.

The Year Begins With Downgrades

BY OLGA BYCHKOVA

U.S.

U.S. credit downgrades outnumbered upgrades in the latest weekly period. The changes issued by Moody's Investors Service spanned a diverse set of speculative-grade industrial and financial companies. Downgrades comprised four of the five rating changes and 100% of affected debt.

The largest downgrade, accounting for 71% of debt affected in the period, was issued to Cumulus Media New Holdings Inc. with its corporate family rating, senior secured term loan, and senior secured notes ratings lowered to B3 from B2. The outlook was changed to stable from negative. The ratings action reflects the impact of high inflation and recessionary pressures on radio advertising demand, which will cause Cumulus's leverage to increase in 2023, the rating agency said.

A notable downgrade, which impacted 29% of debt affected in the period, was issued to Silvergate Capital Corporation and its bank subsidiary Silvergate Bank, following the downgrade of the bank's standalone baseline credit assessment to ba3 from ba1. Silvergate Capital's long-term issuer rating was cut to B1 from Ba2, while the bank's long-term deposit rating was lowered to Ba1 from Baa2 and its long-term issuer rating to B1 from Ba2. Moody's Investors Service also downgraded the bank's short-term deposit rating to Not Prime from Prime-2. The outlook remains negative.

The ratings downgrade follows the bank's announcement of significantly decreased fintech deposits, the crystallization of large losses driven by the sale of securities to meet its liquidity needs, impairment of technology assets associated with a scaling back in its business plan, and the bank's intent to reduce its workforce by 40%, the rating agency said. It added that these events highlight Silvergate Bank's significant operating challenges, in particular the profitability, funding, and liquidity risk associated with amplified deposit volatility driven by uncertainty in the crypto currency market and the bank's narrow business model. In addition, Moody's believes that the risks to Silvergate's business model and franchise value have increased following the joint statement from U.S. federal banking regulators released earlier this month on crypto-asset risks to banking organizations. Almost all of the bank's deposits continue to be from crypto currency centric institutions, and while the bank currently has adequate liquidity and capital, continued large outflows of these deposits would further adversely impact the bank's financial condition.

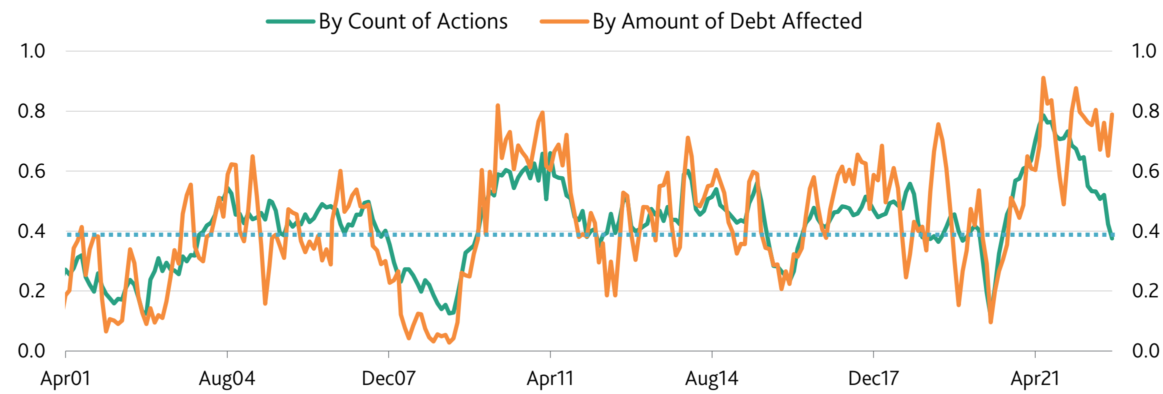
According to Moody's Investors Service, the negative outlook indicates that a ratings upgrade is unlikely over the next 12 to 18 months. The outlook could return to stable if the bank's regulatory and legal risk declines; if volatility in the crypto currency market subsides reducing the risk of further declines in deposits from crypto currency centric firms; and if the bank maintains its current liquidity and strong capitalization levels.

Europe

Rating activity was lighter across Western Europe with Moody's Investors Service issuing just two downgrades. The first, accounting for 100% of debt affected in the period, was issued to U.K.-based speculative-grade industrial firm Coventry and Rugby Hospital Company Plc, which saw its underlying rating for the GBP407.2 million index-linked guaranteed senior secured bonds (including GBP35 million of variation bonds) due 2040 lowered to Ba3 from Ba2. The downgrade follows the company's disclosure on 15 December that it expects to have insufficient cashflow to fully fund contractually required reserve amounts on 31 December and subsequent payment dates, leading to limited financial flexibility, which lessens the firm's ability to manage further payment deductions if they cannot be passed down to the relevant subcontractors, or to manage the impact of other unexpected shocks, according to the rating agency.

The second downgrade was issued to Luxembourg-based speculative-grade industrial company CatLuxe Acquisition S.a.r.l. with its corporate family rating cut to Ca from Caa2, probability of default rating lowered to C-PD from Caa2-PD, and senior secured bank credit facilities, consisting of a EUR215 million senior secured term loan B and a EUR45 million senior secured revolving credit facility, decreased to Ca from Caa1. The outlook remains negative. The ratings action reflects Moody's Investors Service's view that the company's probability of default, including the potential for a restructuring that Moody's considers a distressed exchange, is very high over the near term. The negative outlook on the ratings reflects the high likelihood of default on the senior secured first lien bank credit facilities over the coming months if the announced debt restructuring transaction concludes successfully, the rating agency said.

FIGURE 1
Rating Changes - US Corporate & Financial Institutions: Favorable as a % of Total Actions



* Trailing 3-month average
Source: Moody's

FIGURE 2
Rating Key

BCF	Bank Credit Facility Rating	MM	Money-Market
CFR	Corporate Family Rating	MTN	MTN Program Rating
CP	Commercial Paper Rating	Notes	Notes
FSR	Bank Financial Strength Rating	PDR	Probability of Default Rating
IFS	Insurance Financial Strength Rating	PS	Preferred Stock Rating
IR	Issuer Rating	SGLR	Speculative-Grade Liquidity Rating
JrSub	Junior Subordinated Rating	SLTD	Short- and Long-Term Deposit Rating
LGD	Loss Given Default Rating	SrSec	Senior Secured Rating
LTCF	Long-Term Corporate Family Rating	SrUnsec	Senior Unsecured Rating
LTD	Long-Term Deposit Rating	SrSub	Senior Subordinated
LTIR	Long-Term Issuer Rating	STD	Short-Term Deposit Rating

FIGURE 3

Rating Changes: Corporate & Financial Institutions - US

Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	IG/ SG
01/05/2023	DIEBOLD NIXDORF, INC.	Industrial	PDR		U	D	Caa2	SG
01/05/2023	CSC SERVICEWORKS, INC.	Industrial	SrSec/BCF/LTCFR/PDR		D	B3	Caa1	SG
01/05/2023	SILVERGATE CAPITAL CORPORATION	Financial	LTIR/STD/LTD/PS	200.0	D	Ba3	B1	SG
01/09/2023	CUMULUS MEDIA INC.	Industrial	SrSec/SrSec/BCF/LTCFR/PDR	500.0	D	B2	B3	SG
01/09/2023	BW NHHC HOLDCO, INC.	Industrial	SrSec/BCF/PDR		D	Caa3	D	SG

Source: Moody's

FIGURE 4

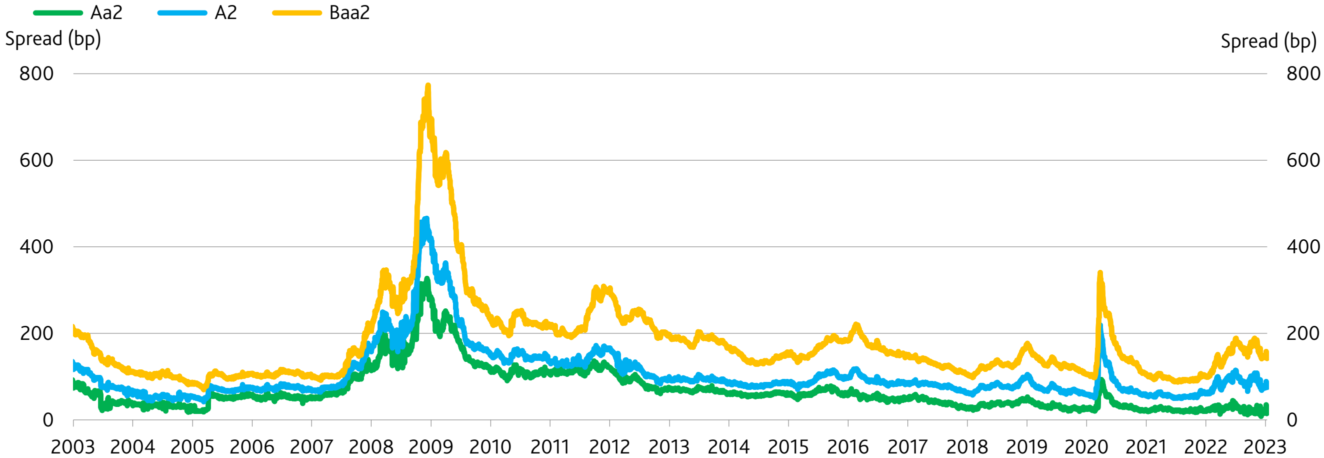
Rating Changes: Corporate & Financial Institutions - Europe

Date	Company	Sector	Rating	Amount ($ Million)	Up/ Down	Old LTD Rating	New LTD Rating	IG/ SG	Country
01/10/2023	COVENTRY AND RUGBY HOSPITAL COMPANY PLC (THE)	Industrial	SrSec	490.5785	D	Ba2	Ba3	SG	UNITED KINGDOM
01/10/2023	CATLUXE ACQUISITION S.A.R.L.	Industrial	SrSec/BCF/LTCFR/PDR		D	Caa2	C	SG	LUXEMBOURG

Source: Moody's

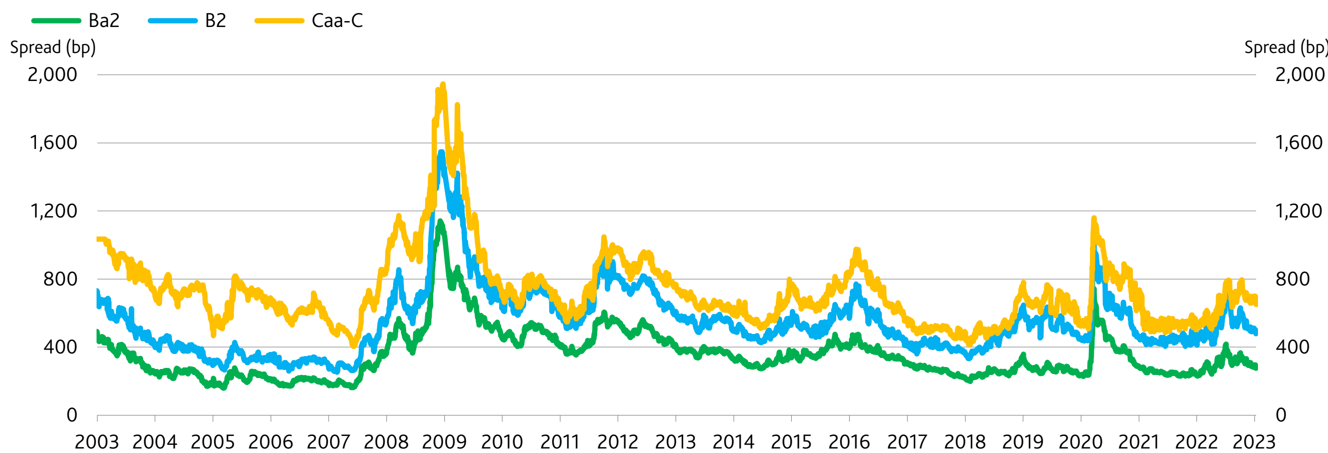
MARKET DATA

Figure 1: 5-Year Median Spreads-Global Data (High Grade)



Source: Moody's

Figure 2: 5-Year Median Spreads-Global Data (High Yield)



Source: Moody's

CDS Movers

Figure 3. CDS Movers - US (January 4, 2023 – January 11, 2023)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Jan. 11	Jan. 4	Senior Ratings
DTE Energy Company	Baa1	Baa3	Baa2
JPMorgan Chase & Co.	A3	Baa1	A1
Citigroup Inc.	Baa1	Baa2	A3
Wells Fargo & Company	A3	Baa1	A1
Oracle Corporation	Baa1	Baa2	Baa2
Citibank, N.A.	Baa2	Baa3	Aa3
Merck & Co., Inc.	A1	A2	A1
Honeywell International Inc.	Aa1	Aa2	A2
Carnival Corporation	Caa3	Ca	B3
PNC Financial Services Group, Inc.	Aa2	Aa3	A3

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Jan. 11	Jan. 4	Senior Ratings
United States of America, Government of	Aa1	Aaa	Aaa
American Honda Finance Corporation	A3	A2	A3
Amazon.com, Inc.	A1	Aa3	A1
CVS Health Corporation	A3	A2	Baa2
3M Company	Aa3	Aa2	A1
Enterprise Products Operating, LLC	A3	A2	Baa1
Thermo Fisher Scientific Inc.	A2	A1	A3
Gilead Sciences, Inc.	A3	A2	A3
Truist Financial Corporation	Baa3	Baa2	A3
Visa Inc.	A2	A1	Aa3

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Jan. 11	Jan. 4	Spread Diff
Rite Aid Corporation	Caa2	4,953	4,319	634
Service Properties Trust	B2	548	479	69
iHeartCommunications, Inc.	Caa1	595	556	39
Harley-Davidson, Inc.	Baa3	180	163	17
Old National Bancorp	A3	108	93	14
JBS USA Lux S.A.	Baa3	207	196	12
Southern Copper Corporation	Baa1	91	80	11
Interpublic Group of Companies, Inc. (The)	Baa2	129	119	11
Southern California Edison Company	Baa2	123	115	9
American Tower Corporation	Baa3	135	126	9

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Jan. 11	Jan. 4	Spread Diff
Carnival Corporation	B3	1,160	1,452	-292
American Airlines Group Inc.	Caa1	1,009	1,205	-196
Domtar Corporation	Ba3	608	757	-149
Freedom Mortgage Corporation	B2	775	907	-132
Anywhere Real Estate Group LLC	B2	893	1,020	-128
Unisys Corporation	B3	913	1,037	-123
K. Hovnanian Enterprises, Inc.	Caa2	914	1,037	-122
Staples, Inc.	Caa2	1,584	1,697	-113
United Airlines Holdings, Inc.	Ba3	599	697	-99
CSC Holdings, LLC	B1	1,252	1,335	-82

Source: Moody's, CMA

CDS Movers

Figure 4. CDS Movers - Europe (January 4, 2023 – January 11, 2023)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Jan. 11	Jan. 4	Senior Ratings
London Stock Exchange Group plc	Aa3	A2	A3
United Kingdom, Government of	Aaa	Aa1	Aa3
Belgium, Government of	Aaa	Aa1	Aa3
Portugal, Government of	Aa3	A1	Baa2
Greece, Government of	Baa2	Baa3	Ba3
Danske Bank A/S	A2	A3	A3
Standard Chartered PLC	Baa1	Baa2	A3
Bayerische Motoren Werke Aktiengesellschaft	A2	A3	A2
Deutsche Telekom AG	Aa3	A1	Baa1
Equinor ASA	Aa1	Aa2	Aa2

CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Jan. 11	Jan. 4	Senior Ratings
Legrand France S.A.	A1	Aa2	A3
BPCE	A2	A1	A1
Societe Generale	A3	A2	A1
ABN AMRO Bank N.V.	A2	A1	A1
UniCredit S.p.A.	Baa3	Baa2	Baa1
DZ BANK AG	A2	A1	Aa2
Lloyds Banking Group plc	Baa1	A3	A3
Natixis	A2	A1	A1
Landesbank Hessen-Thueringen GZ	Baa1	A3	Aa3
Bayerische Landesbank	A2	A1	Aa3

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Jan. 11	Jan. 4	Spread Diff
Garfunkelux Holdco 3 S.A.	Caa2	1,090	1,064	26
CPI Property Group	Baa3	661	642	19
Close Brothers Group plc	A2	133	122	11
Close Brothers Finance plc	Aa3	135	124	11
Bankinter, S.A.	Baa1	111	103	8
Legrand France S.A.	A3	48	40	8
Landesbank Hessen-Thueringen GZ	Aa3	73	66	7
NIBC Bank N.V.	Baa1	185	179	6
Norddeutsche Landesbank GZ	A3	104	100	5
Orsted A/S	Baa1	56	52	5

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Jan. 11	Jan. 4	Spread Diff
Boparan Finance plc	Caa3	1,663	2,031	-368
Carnival plc	B3	1,100	1,377	-277
Vedanta Resources Limited	Caa1	2,175	2,393	-218
Iceland Bondco plc	Caa2	1,042	1,260	-218
Casino Guichard-Perrachon SA	Caa1	2,527	2,686	-160
Ardagh Packaging Finance plc	Caa1	761	850	-89
Novafives S.A.S.	Caa2	919	1,002	-83
Trinseo Materials Operating S.C.A.	B2	766	833	-68
United Group B.V.	Caa1	1,003	1,061	-58
CECONOMY AG	B1	933	991	-57

Source: Moody's, CMA

CDS Movers

Figure 5. CDS Movers - APAC (January 4, 2023 – January 11, 2023)

CDS Implied Rating Rises	CDS Implied Ratings		
Issuer	Jan. 11	Jan. 4	Senior Ratings
Vanke Real Estate (Hong Kong) Company Limited	Ba2	B2	Baa2
SGSP (Australia) Assets Pty Ltd	A3	Baa2	A3
China, Government of	A2	A3	A1
Korea, Government of	Aa3	A1	Aa2
Export-Import Bank of China (The)	A2	A3	A1
China Development Bank	A3	Baa1	A1
Kookmin Bank	Aa3	A1	Aa3
Transurban Finance Company Pty Ltd	Baa2	Baa3	Baa2
Bank of China Limited	Baa1	Baa2	A1
Korea Gas Corporation	Baa1	Baa2	Aa2

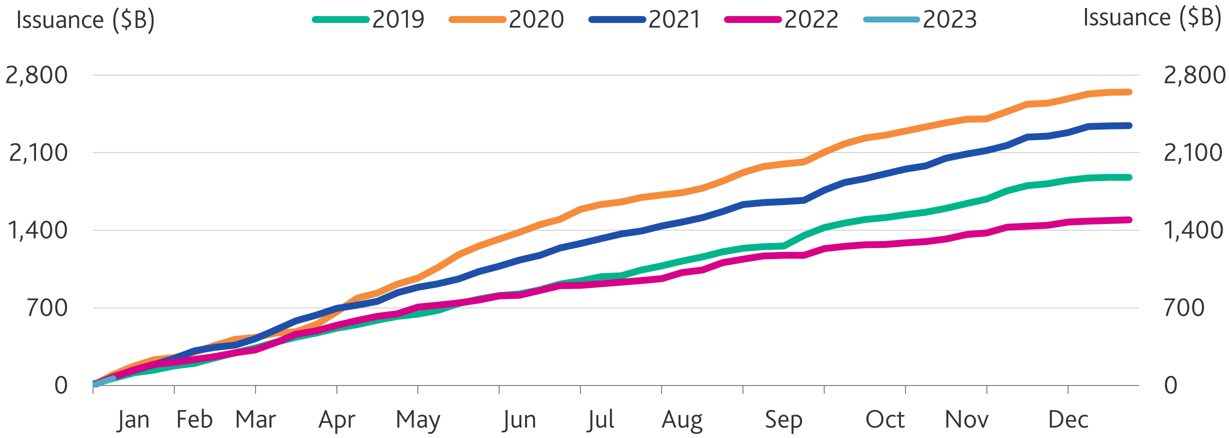
CDS Implied Rating Declines	CDS Implied Ratings		
Issuer	Jan. 11	Jan. 4	Senior Ratings
Development Bank of Japan Inc.	A2	A1	A1
Mizuho Bank, Ltd.	A2	A1	A1
Indian Railway Finance Corporation Limited	Baa3	Baa2	Baa3
JFE Holdings, Inc.	A2	A1	Baa3
Woolworths Group Limited	Baa1	A3	Baa2
ORIX Corporation	A2	A1	A3
Marubeni Corporation	Aa2	Aa1	Baa2
Rizal Commercial Banking Corporation	Ba1	Baa3	Baa3
Mitsubishi UFJ Securities Holdings Co., Ltd.	A1	Aa3	A1
Tata Motors Limited	Ba3	Ba2	B1

CDS Spread Increases		CDS Spreads		
Issuer	Senior Ratings	Jan. 11	Jan. 4	Spread Diff
Pakistan, Government of	Caa1	4,705	4,309	396
CNAC (HK) Finbridge Company Limited	Baa2	193	174	19
GMR Hyderabad International Airport Limited	Ba3	301	283	18
SK Hynix Inc.	Baa2	211	195	17
Development Bank of Kazakhstan	Baa2	212	205	7
Flex Ltd.	Baa3	130	124	6
SK Innovation Co. Ltd.	Baa3	330	324	6
Tata Motors Limited	B1	316	312	4
JFE Holdings, Inc.	Baa3	59	56	3
NIPPON STEEL CORPORATION	Baa2	53	50	3

CDS Spread Decreases		CDS Spreads		
Issuer	Senior Ratings	Jan. 11	Jan. 4	Spread Diff
Vanke Real Estate (Hong Kong) Company Limited	Baa2	248	420	-172
Adani Green Energy Limited	B2	548	595	-47
Transurban Finance Company Pty Ltd	Baa2	84	116	-32
Sydney Airport Finance Company Pty Ltd	Baa1	91	119	-28
Qantas Airways Ltd.	Baa2	147	175	-27
Lenovo Group Limited	Baa2	268	292	-25
Aurizon Network Pty Ltd	Baa1	93	117	-24
SoftBank Group Corp.	Ba3	398	419	-22
Bank of East Asia, Limited	A3	85	106	-21
SGSP (Australia) Assets Pty Ltd	A3	67	88	-21

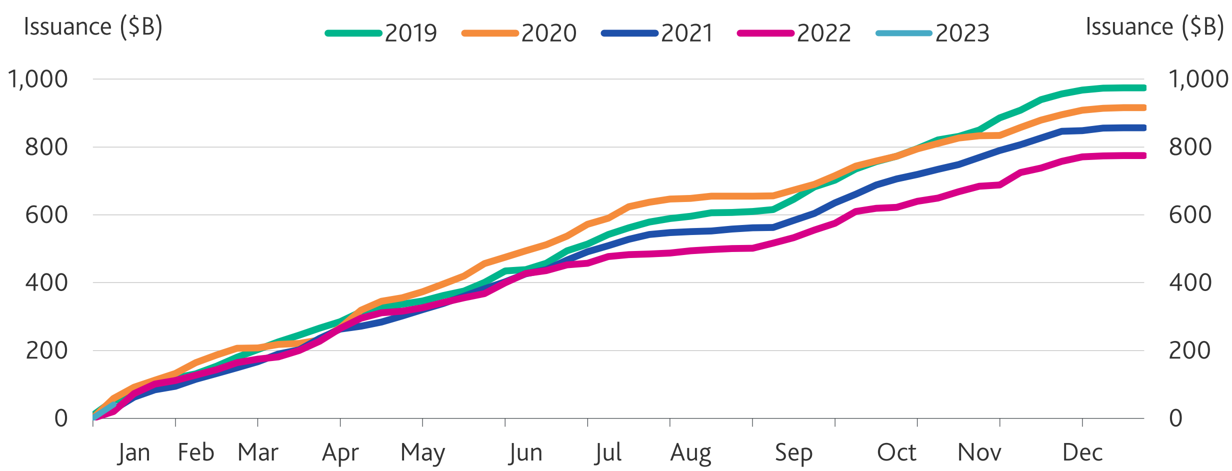
Source: Moody's, CMA

Figure 6. Market Cumulative Issuance - Corporate & Financial Institutions: USD Denominated



Source: Moody's / Dealogic

Figure 7. Market Cumulative Issuance - Corporate & Financial Institutions: Euro Denominated



Source: Moody's / Dealogic

Figure 8. Issuance: Corporate & Financial Institutions

	USD Denominated		
	Investment-Grade	High-Yield	Total*
	Amount $B	Amount $B	Amount $B
Weekly	61.014	2.750	63.809
Year-to-Date	61.440	2.750	64.247

	Euro Denominated		
	Investment-Grade	High-Yield	Total*
	Amount $B	Amount $B	Amount $B
Weekly	37.387	1.854	41.093
Year-to-Date	37.387	1.854	41.093

* Difference represents issuance with pending ratings.

Source: Moody's/ Dealogic

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Editor
Reid Kanaley
helpeconomy@moodys.com

Contact Us
Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com