Research Marketing

10 Key Themes from Strategy and Macro Year Aheads

Investment Strategy

This is a redaction of a 14 page report published on December 12, 2022.

10 Key Themes from BofA Macro/Strategy Teams for ’23

1) **Markets turn “risk on” in mid ‘23:** Suggest investors long bonds, particularly 30y UST and steepeners in 1H23 as recession and credit shocks hit risk assets. Near term market risk as Earnings Per Share (EPS) forecasts are slashed (US Strategy estimates $200 for ’23), but S&P 500 typically bottoms 6M ahead of recession end, suggesting a rebound starting around mid-year. – Subramanian
2) **A recession is all but inevitable in the US, Euro Area and UK:** Expect a mild US recession in 1H23 with risk that it starts later. Europe likely sees recession this winter with shallow recovery thereafter as real incomes and likely overtightening pressure demand. – Harris/Gapen/Segura-Cayuela/Wood
3) **Rates stay elevated but expect a decline by YE ‘23:** We expect the yield curve to dis-invert & rates vol to fall. We estimate both 2Y & 10Y US Treasuries to end ‘23 at 3.25%. Sectors hurt by rising rates in ’22 may benefit in ‘23. – Cabana
4) **China reopening happens but could be bumpy until later in ‘23:** We expect a gradual China reopening starting now with most curbs removed 2H23 (BofA ’23 China Gross Domestic Product (GDP) forecast well above consensus at 5.5%). – Qiao
5) **After a volatile 1Q23, EM should produce strong returns:** Once inflation and rates peak in the US and China reopens, the outlook for EM should turn more favorable. We forecast the highest regional local debt/foreign exchange (FX) market return for Eastern Europe, Middle East and Africa (EEMEA), then Latin America and Asia. – Hauner. Ajay Kapur turned more positive on China equities on a reversal in both zero-COVID and property tightening. – Kapur
6) **After a historically bad year for industrial metals in ’22, cyclical and secular drivers boost metals in ’23, & copper rallies ~20%:** Recessions in key markets are a headwind but China reopening, a peaking dollar and especially an acceleration of renewables investment more than offset these negative factors. – Widmer
7) **Higher for longer oil prices:** Russian sanctions, low oil inventories, China reopening, and an OPEC that’s willing to cut production in case demand weakens keeps energy prices high. Brent Crude should average $100 per barrel over the course of 2023 and spike in the second half of the year at $110. – Blanch
8) **Reshoring CapEx remains strong, even in recession:** Strong labor market, ESG, US/China decoupling and deglobalization/reshoring keeps certain areas of capex strong, even in the event of a recession. – Subramanian
9) **Consumer gets some relief on prices, but also becomes less willing to spend given wealth effect and as labor markets worsen:** Labor markets finally ease and US unemployment peaks at 5.5% in 1Q24. – Gapen
10) **The end of Fed hikes and more conservative corporate balance sheet management leads to a positive backdrop for credit:** Weaker prospects for growth and higher rates leads managements to shift prioritization to debt reduction from share buybacks and capex. US IG Strategist Yuri Seliger sees a ~9% total return from IG credit in ’23. HY Strategist Oleg Melentyev estimates a default rate peak of 5%, far below past recessions. – Seliger/Melentyev

03 January 2023 Corrected

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1. Markets turn "risk-on" in mid-'23, bonds to do well in 1H

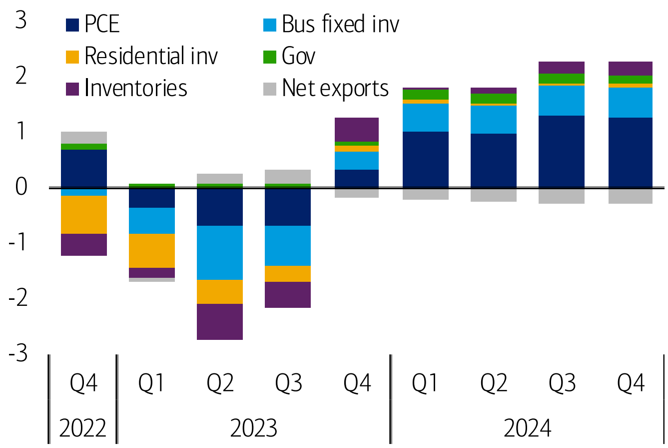
BofA Global Research Reports Highlighting the Theme:

Michael Hartnett – "We stay bearish risk assets in H1, set to turn bullish H2 as narrative shifts from the inflation and rates "shocks" of '22 to recession and credit "shocks" in H1'23, then bullish "peak" inflation, Fed, US$ in H2'23; recession…long bonds in H1, Fed rate cuts…long stocks and credit in H2."

Savita Subramanian – "S&P 500 2023 year-end target 4000…In the near term, pain from EPS cuts (estimates are 15% higher than our 2023 forecast of $200)…The market typically bottoms six months before the end of a recession, so buy in 1H based on our economists forecast of the recession ending by 3Q 2023…Own Quality, income, reshoring, green+brown, small caps.

2. Recession is all but inevitable in the US, Euro Area and UK

Exhibit 1: Forecasted contributions to quarterly GDP growth (pp)
Investment- and consumer-led slowdown



Source: Bureau of Economic Analysis, Haver Analytics, BofA Global Research
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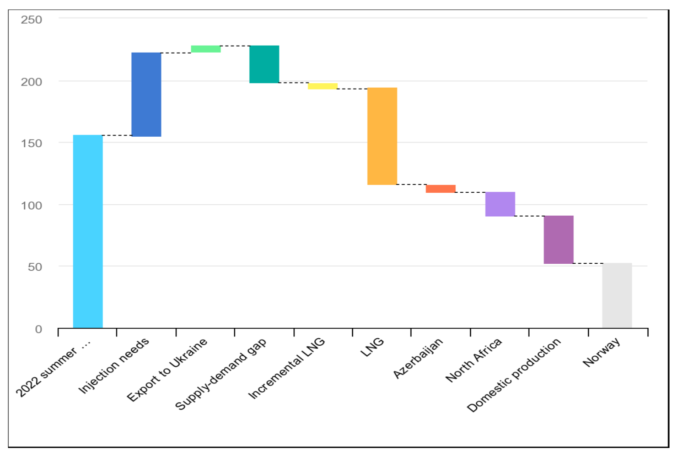
Exhibit 2: Summer-23 gas balance of the EU and UK (bcm)
Without Russian gas flows and limited LNG supply even an 11% demand reduction could imply a 30bcm gas supply shortage in Europe



Source: International Energy Agency "Never Too Early to Prepare for Next Winter", Nov-22
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BofA Global Research Reports Highlighting the Theme:

Ethan Harris – "A recession is very likely in the US, Euro Area and UK. Other regions will continue to weaken, with the exception of China. Inflation will come down, but it will take time for central banks to declare victory. The outlook is much more uncertain than normal and we continue to worry about geo-political shocks and sticky-high inflation."

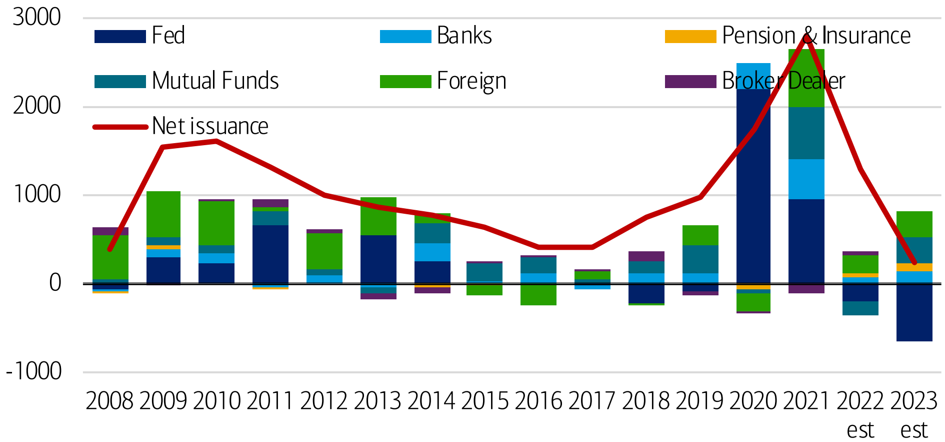
Michael Gapen – "Our outlook for a mild recession in the US economy is driven by weaker investment and consumer spending. Within investment, the sharpest decline should come from residential investment, though spending in structures and equipment may slow as overall demand slows. We think the headwinds of a weaker labor market, higher borrowing costs, tighter credit standards, and weaker balance sheets will lead consumers to reduce spending temporarily and push the saving rate higher."

Ruben Segura-Cayuela, Rob Wood – "A [Euro Area] recession this winter seems unavoidable given the cumulative real income squeeze and the need for energy-saving/small "rationing"… UK enters six quarter recession as rate hikes and falling real incomes hit consumers. But very weak UK supply side could keep inflation elevated."

3. Rates stay elevated but expect a decline by year-end '23

Exhibit 3: Large Treasury investor demand & coupon issuance

Expect end user demand to be more supported in 2023 ($bn)



Source: BofA Global Research, Federal Reserve, Note: only reflects real money categories from flow of funds that generally invest in Treasury coupon securities, excludes households. Last data point for 2022 is June from Flow of Funds, 2022 reflects estimate based on realized flows from other data sources since end of Q2

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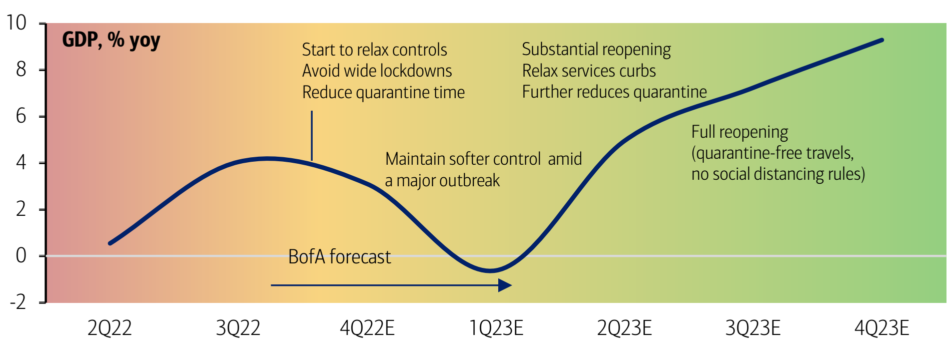
BofA Global Research Reports Highlighting the Theme:

Mark Cabana – Global Rates Year Ahead: Year Ahead 2023: Prepare for landing 20 November 2022 "Macro uncertainty to decline in '23. Lower uncertainty in our forecasts because: slower pace of Fed hikes / eventual pause, falling though still high inflation, softening labor market, USTs regaining their risk-off hedge value with increased demand. Rates to move past their peak & decline in '23, vol to drop, real rates to fall, spread curve likely steeper...Our rate forecasts by end '23 call for 2y & 10y UST each at 3.25%. We expect the UST curve to dis-invert and move towards a positive slope in '24. These forecasts are based on our US economist forecasts but reflect stickier inflation risk."

4. China reopening happens but could be bumpy until later in '23:

Exhibit 4: The bumpy path to reopening

We expect China's growth to rebound after an initial shock when reopening starts



Source: BofA Global Research estimates, National Bureau of Statistics of China.

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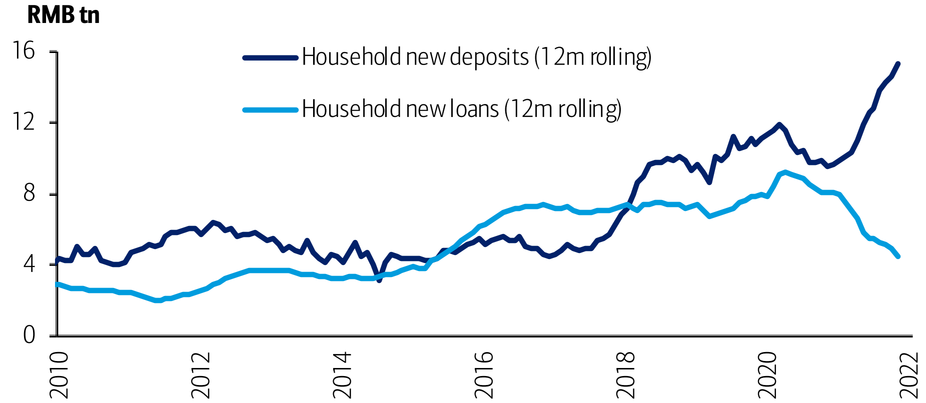
Exhibit 5: Household new deposits and new loans
Household cautionary savings point to pent-up demand



Source: Wind, People's Bank of China, BofA Global Research

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BofA Global Research Reports Highlighting the Theme:

Helen Qiao – "It has been our long-held contrarian view that controls would be relaxed after the 20th Communist Party Congress. That now seems to be happening, with the Politburo signaling a change in tone and National Health Commission rolling out a number of relaxation measures (see report). This implies a domestic demand rebound as China reopens, even without substantial easing in monetary, fiscal, or property policies."

5. After a volatile 1Q'23, EM should produce strong returns:

BofA Global Research Reports Highlighting the Theme:

David Hauner - GEMs Viewpoint: Year Ahead 2023: Re-Emerging Markets 20 November 2022 "2023 is likely to be a year of good returns in EM debt, possibly double-digit. Flows may improve as of January, with seasonally improved risk appetite, but until the Fed hikes are done, volatility is likely to stay elevated, particularly in Q1. We favor local over external debt on a weaker USD. We forecast total USD returns of 12% for local debt and 11% for sovereign credit, based on EUR/USD ending 2023 at 1.10 and US 10-year yields at 3.25%. We forecast the highest regional local market return for EEMEA, then LatAm and Asia."

Ajay Kapur – "For 2023, we are more constructive on Asian/EM equities. China has cut off left tail risk by reversing course on its zero-COVID policy, property tightening and geopolitical relationships…China's regulatory policy is likely to be less onerous, and credit multipliers are likely bottoming as confidence rebounds. Asian Risk-Love (sentiment) is in the panic zone (6th percentile), and positioning is light in north Asian equity markets… Our economists expect peak Fed funds rate of 5.25% in March 2023. In the prior 7 Fed pause events, Asian equities rose a median 15% in the ensuing year, versus a base annual return of 9% since 1980, rising in 5 of 7 episodes."

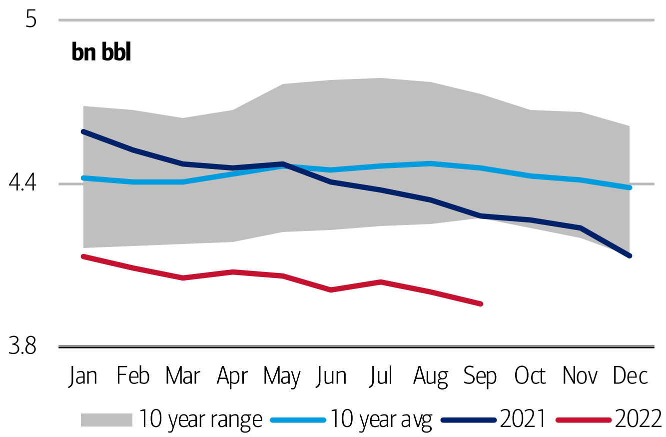
6. After a historically bad year for industrial metals in '22, cyclical and secular drivers boost metals in '23, and copper rallies ~20%.

BofA Global Research Reports Highlighting the Theme:

Michael Widmer – "Copper is set to rally as usage in green technologies should offset cyclical demand weakness…

7. Higher for longer oil prices:

Exhibit 6: OECD total oil stocks
Total petroleum stocks across industry and governments in the OECD are at very low levels



Source: International Energy Agency

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BofA Global Research Reports Highlighting the Theme:

Francisco Blanch – "With spare capacity dwindling and capex lagging, we believe $80/bbl is the new $60 for Brent. While downside risks are somewhat limited, we see upside to oil prices from EU's Russia oil embargo, a faster-than-projected China reopening, and a potential Fed pivot in 1Q23."

8. Reshoring CapEx remains strong, even in recession:

Exhibit 7: Estimated impact of changes to US manufacturing CapEx
Andrew Obin sees the Inflation Reduction Act as adding 1.0% of annual growth to US Capex

2007-2019 Compound Annual Growth Rate (CAGR)	**2.8%**
Announced semi investments	1.8-2.5%
Stable mix of imported intermediary goods	1.00%
American Rescue Plan Act of 2021	1.0-1.5%
Infrastructure Investment and Jobs Act	~0.5%
Inflation Reduction Act	1.00%
2019-2024E CAGR	8.1-9.3%

Source: BofA Global Research, Bureau of Economic Analysis

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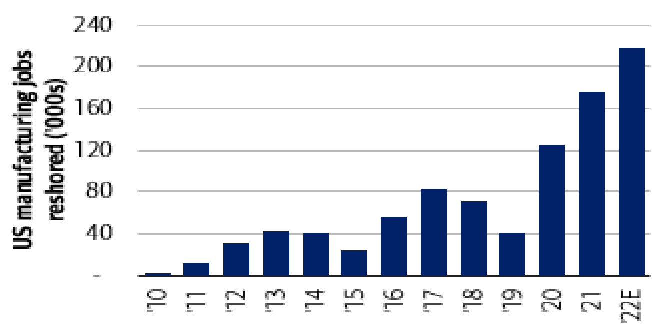
Exhibit 8: US manufacturing jobs from reshoring activities
2021 was a record year for reshoring



Source: AlphaSense, BofA Global Research

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BofA Global Research Reports Highlighting the Theme:

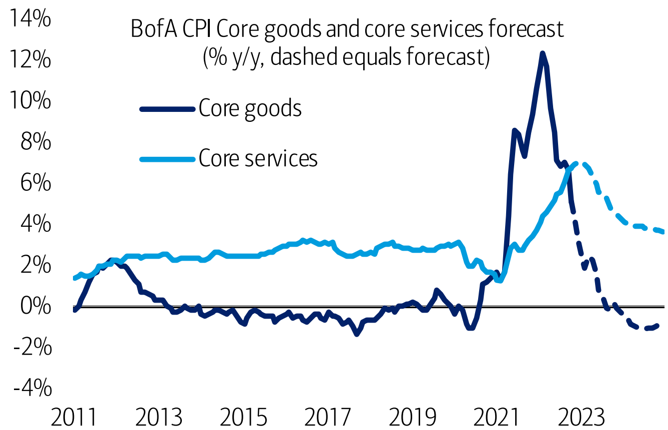
Savita Subramanian – "Reshoring is well underway, and manufacturing capex is likely to eclipse tech spend for the first time in a long while. War + Net Zero means fossil fuels and renewables could outperform simultaneously… Small caps have historically benefitted more from US capex spending than large caps"

Andrew Obin – "Semiconductor capacity announcements are shifting to actual construction, which will benefit overall US manufacturing CapEx, particularly equipment CapEx…We estimate US manufacturing CapEx will grow at an 8-9% CAGR over 2019-2024E. Spreading the $122bn in announced US semiconductor spending over this timeframe adds 1.8-2.5 percentage points of growth to US manufacturing CapEx, by our estimate."

Andrew Obin - "From 2007-2019, US manufacturing CapEx grew at a 2.8% CAGR. Based on announced semi investments and incremental infrastructure spending, we estimate an 8.1%-9.3% CAGR from 2019-2024E (up from ~7% prior)."

9. Consumer to get some relief on prices, but also may become less willing to spend given wealth effect, and as labor markets worsen:

Exhibit 9: BofA CPI core goods and core services forecast (% y/y)
We expect disinflation in 2023 to be driven mainly by weaker goods prices



Source: Bureau of Labor Statistics, Haver Analytics, BofA Global Research

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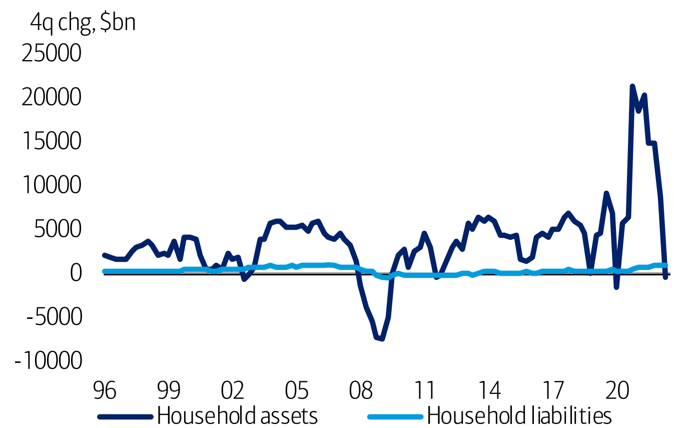
Exhibit 10: Household assets and liabilities ($bn)
Household balance sheets may weaken if financial asset prices and home prices move lower, we expect home prices to fall 5-10% in '22



Source: Bureau of Economic Analysis, Haver Analytics, BofA Global Research

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BofA Global Research Reports Highlighting the Theme:

Michael Gapen – "Our outlook for weaker labor markets is likely to weigh on consumer sentiment, leading to more conservative spending behavior in an environment of greater uncertainty in income and employment prospects. In addition, higher cost of credit and tighter lending standards is likely to weigh on durables spending...Looking ahead to next year, our outlook for declining home prices and the potential for weaker equity market performance may lead the average household to prefer a higher saving rate over a lower one, softening spending in the process."

10. The end of Fed hikes and more conservative corporate balance sheet management should lead to a positive backdrop for credit:

BofA Global Research Reports Highlighting the Theme:

Yuri Seliger – "Moderation in interest rate risks is the key reason for our 6M spread target of 130bps on ICE BofA US IG corporate index, down from 139bps currently. US and global growth should slow and corporate earnings will likely drop into the negative territory. Offsetting that will be conservative balance sheet management and declining debt.....Demand should improve due to IG credit positioning normalizing from some of the biggest underweights currently."

Oleg Melentyev – High Yield Strategy: Year Ahead 2023, 21 November 2022 "Tail risks recede and issuer fundamentals are in good shape to take the initial impact from higher rates and recession…Issuers will likely be prioritizing debt reduction as old cap structures do not work given the new realities of higher rates."

Larry Bland – US Credit Research: Capital Allocation: Thinking Like a CFO 15 November 2022 "All sectors will face materially higher cost of debt capital and refinancing rates in 2023."

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