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What to watch: Impact of the Red Sea crisis, US inflation back to target this year?, pivotal elections in Taiwan, life after the yearend market rally

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Executive Summary

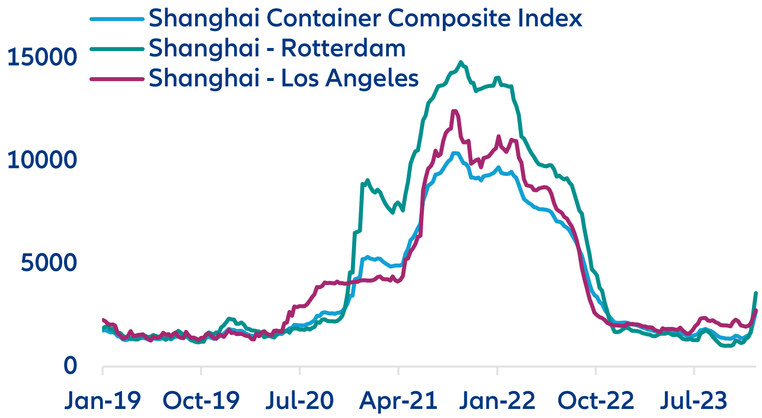
This week, we look at four critical issues:

- First, **Red Sea crisis: not a red flag for the global economy (yet)**. Houthi attacks in the Red Sea have disrupted a vital trade route, leading to costlier and time-consuming rerouting around Africa. Shipping prices, including container freight, surged by +240% since November 2023, reaching levels seen in Q4 2022, but well below the 2021 peak for now. Short-lasting disruptions would contain the impact on the global economy. As demand in the US and Europe is –10% below those levels, stocks remain high and industrial firms' margins have room to absorb rises in input prices. However, if the crisis persists for several months, a doubling of shipping prices would push global inflation up by +0.5pp, resulting in a -0.4pp reduction in GDP growth. Energy prices are the most vulnerable factor, as 12% of seaborne oil and 8% of liquefied natural gas pass through the Suez Canal, causing energy prices in Europe to remain highly volatile.
- Second, **US inflation – back to the Fed's target in 2024?** The December CPI data was stronger than expected. Nevertheless, forward-looking indicators on food and shelter inflation appear encouraging. With wages expected to keep growing strongly in 2024 (though easing from 2023) our analysis suggests that a mere 0.3pp drop in corporate margins could bring inflation to around 2.3%, broadly aligning with the Fed's target. This seems achievable, considering corporate margins currently stand well above the pre-pandemic implied trend and amid a slowing US economy.
- Third, the **Taiwanese head to the polls this Saturday** to elect a new president and parliament. Apart from domestic concerns, these elections involve high stakes for Taiwan's relationship with China, US-China tensions and global supply chains. Recent polls indicate that the more China-sceptic candidate, Lai Ching-te, will likely win the presidential election. Nevertheless, cross-strait tensions should be contained (at least in the short-term) with the opposition likely snatching a majority in parliament.
- Fourth, **everything is higher all at once – capital markets posted strong returns in the final quarter of 2023** due to a sudden optimism about faster rate cuts. This shift followed dovish central bank meetings and a rapid disinflation trend. However, valuations for bonds and equities appear stretched, raising concerns for 2024, especially if central banks fail to deliver the number of cuts currently priced in by the markets. We still expect positive but considerably lower returns amid heightened volatility.

Red Sea crisis: not a red flag for the global economy (yet)

Shipping: expect longer routes and higher costs. The Houthi attacks on commercial ships in the Red Sea have triggered significant disruptions in the shipping industry. The situation remains fluid and tense as a US-led coalition launched airstrikes against the Houthis on the night of January 11th. Shipping companies have been forced to opt for costlier and more time-consuming routes around Africa to avoid the risks in the Red Sea region. The Red Sea is a vital route, accounting for one-third of worldwide container traffic and 40% of Asia-Europe trade. Some 12% of seaborne oil and 8% of liquefied natural gas (LNG) pass through the Suez Canal. Furthermore, the attacks have had a noticeable impact on shipping volume. In the ten days leading up to Jan 7, shipping volumes in the Suez Canal declined by -15% year-on-year, while the Bab-el-Mandeb Strait leading into the Red Sea saw a more substantial fall of -53%. The number of cargo ships passing through the Suez Canal decreased by -30% for cargo and -19% for tankers. In contrast, shipping volume around the Cape of Good Hope nearly doubled during the same period, with cargo ships increasing by +66% and tankers by +65%. While shipping prices, especially container freight, have risen significantly since November 2023 (+240% as of early January – see Figure1), they are still only a quarter of the peak in 2021. This is partially due to weak demand and higher inventories in most consumer goods segments (e.g. as of Q3 2023, inventories of Western European Corporates increased by 2 days of turnover in the auto sector and up to +14 days of turnover for transport equipment firms). The shipping sector has also expanded its capacities with new container ships, so the upside risk although significant seems lower today than in 2021. Especially, should this crisis persist beyond the first semester of the year, the impact on global supply chains could become more severe.

Figure1: Container price indices

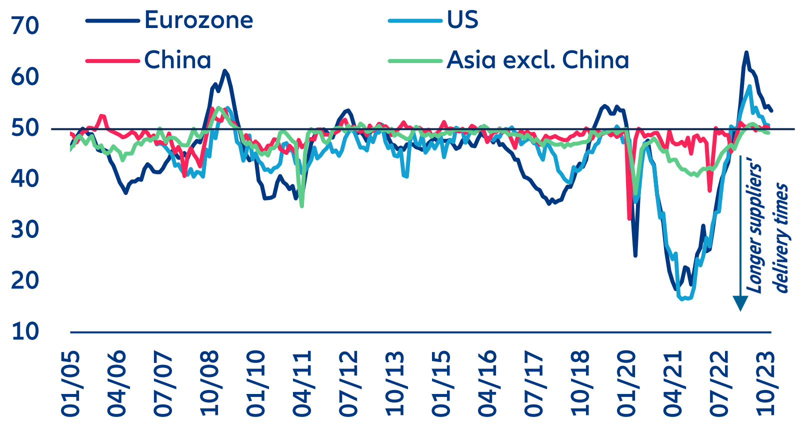


Sources: LSEG Datastream, Allianz Research

Long-term elasticities indicate that the impact of rising logistic costs on inflation, GDP and trade will remain manageable if disruptions remain short-lived. Unsurprisingly, the effect of increasing shipping costs on inflation is highest in Europe and the US, where a doubling of shipping costs can push inflation up by +0.7pp compared to +0.3pp for China. This would mean a +0.5pp increase to 5.1% for global inflation in 2024. GDP growth could be negatively affected by -0.9pp for Europe and -0.6pp for the US, potentially translating into a -0.4pp reduction in global GDP growth to 2%. The positive news is that suppliers' delivery times have normalized and are lower than pre-pandemic averages (see Figure 2). However, should this crisis extend over several months, global trade growth in volume could be impacted, potentially reducing it by -1.1pp to +1.9%. This increases the risk of a delayed rebound from the 2023 recession. From a corporate perspective, margins could decrease by as much as -1.8pp in Europe and -0.9pp in the US if firms, hence, absorbing 50% of the input price increases. Nevertheless, such declines would stil mean profitability slightly lower than in 2019.

European energy prices remain highly volatile. We see energy prices as the most vulnerable channel through which the ongoing crisis could impact the global economy, especially Europe. Indeed, between November 17th and November 22nd, after the first Houthi rebel attacks were reported, Brent price – the European benchmark for oil prices increased by close to 2%, while the US WTI price remained broadly unchanged. Over a five-day window around that date, natural gas prices in Europe also increased by +3.6%. We saw similar patterns of periodic stress in intra-day trading when attacks were reported in late December. However, oil prices continue to decline. This stems from several factors (i) oil traders remain focused on recent news pointing towards higher-than-expected supply, (ii) concerns about global demand and (iii) tankers continue to sail through the Red Sea. Regarding European natural gas prices, we do not expect supply tensions to significantly impact prices in the short run as reserves are high and the heating season is already drawing to its end (despite the recent cold snap).

Figure 2: Suppliers' delivery times in the manufacturing sector, below 50 = longer delivery times



Sources: LSEG Datastream, Allianz Research

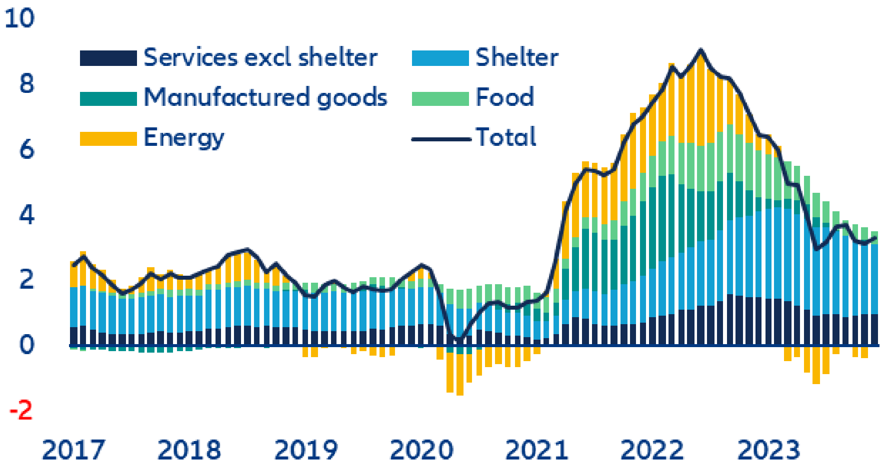
US inflation – back to the Fed's target in 2024?

The December CPI report was a notch stronger than expected, but the path towards complete inflation normalization in 2024 remains unchanged.

Headline CPI inflation increased by +0.3% over the month, pushed by increases in medical, auto, airlines and shelter. On a year-on-year basis, headline inflation ticked up to +3.3% (+0.2pp from November), while core inflation eased slightly at +3.9%. Examining the year-on-year breakdown (Figure 3), we observe that goods inflation has fully returned to pre-pandemic level since early 2023, while food inflation is also approaching normalization. The trend in lower goods and food inflation mainly reflects the unwinding of supply shocks that drove up inflation in the US and globally in late 2021 and 2022. On the other hand, services excluding shelter have been more resilient to normalization, reflecting the higher share of labor costs in services compared to goods and food items, but encouragingly the month-on-month pace eased in December to +0.2%.

Food and shelter inflation is expected to decline further in 2024. Upstream price pressures in the food industry continue to ease rapidly, suggesting a further softening of y/y food CPI in the first half of 2024 (Figure 4a), potentially even into negative territory (although this is not our base case). Similarly, shelter inflation, which holds an outsized weight in the CPI basket (about 35%), has only modestly eased throughout 2023 (Figure 4b). However, the Zillow rental index indicates a trend towards softer shelter inflation over the next 12 months and full normalization by the end of the year. In summary, our long-standing view is that US headline CPI inflation should hover close to 2% year-on-year by the summer of 2024.

Figure 3: Sectoral contributions to year-on-year headline CPI (p.p.)



Sources: LSEG Datastream, Allianz Research.

Figure 4a: Food CPI & food PPI (input to stage 1)

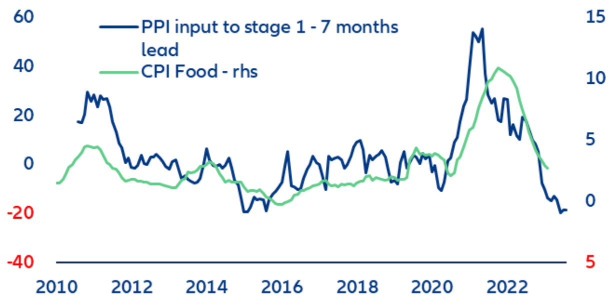
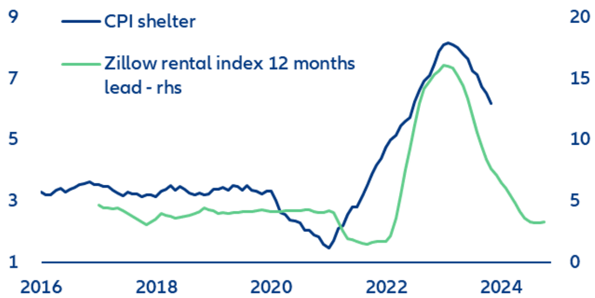


Figure 4b: Shelter CPI & Zillow rental index (% y/y)



Sources: LSEG Datastream, Allianz Research.

High wage demands to recoup lost purchasing power are unlikely to re-reignite inflationary pressures in 2024 because corporate margins would need to drop by only 0.3pp.

Inflation-adjusted wages have dropped by a cumulative -1.5pp between 2021 and 2023.[1] Consequently, wage earners still have some way to go before fully recouping their purchasing power losses since the pandemic recovery. Concerns have arisen among policymakers and market participants that catch-up wage growth could trigger a wage-price loop, preventing the Fed from reaching its 2% inflation target in the near term. Although the easing of the labor market is curbing nominal wage growth, we still expect nominal wages to grow at a still elevated pace of slightly below +4% in 2024, down from +4.7% in 2023. Assuming an average inflation rate of +2.3% this year, US workers would regain all their purchasing losses in 2024.

Is 4% nominal wage growth compatible with inflation close to 2%? Using the National Accounts, we dissected the components of quarterly y/y US inflation (Figure 5a) into its six accounting contributors, through Q3-2023 (latest data available): unit labor costs, unit taxes (net of subsidies), unit margins (gross operating surplus, pre-tax and interest expenses and depreciation), relative deflators, terms of trade (the difference between export and import prices) and a statistic correction.[2] Through 2023, corporate margins' contribution to inflation significantly receded (down to -1pp in Q3-2023) following outsized contributions in 2020-22 when corporates sharply raised their selling prices amid elevated demand. The contribution of unit labor costs has also eased, albeit more modestly, contributing to a still elevated +1.3pp inflation in Q3-2023.

[1] We look at the Atlanta Fed wage growth tracker, which more accurately reflects workers' wage income than the average hourly earnings or the compensation per employee data.

[2] The statistic correction spiked over the past few quarters because of the widening divergence between GDP and GDI.

Figure 5a: Year-on-year CPI inflation breakdown (p.p.)

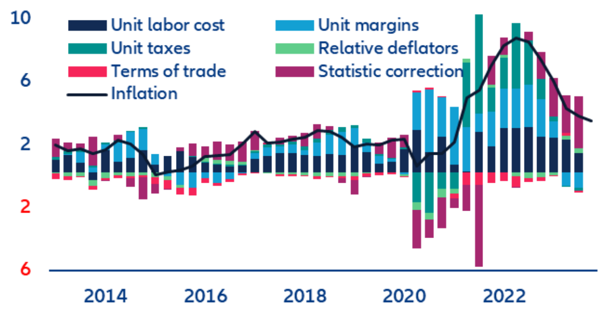
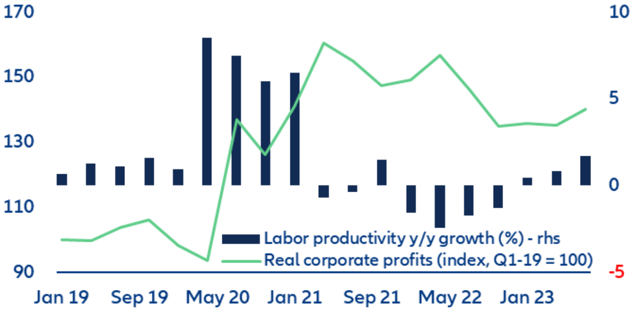


Figure 5b: Corporate profits & labor productivity growth



Sources: LSEG Datastream, Allianz Research.

Corporate post-tax profits (after tax, interest and depreciation) are currently 32% higher in inflation-adjusted terms compared to pre-pandemic levels.[3] Additionally, productivity growth is picking back up, lowering unit costs (Figure 5b). Therefore, with a slowing US economy in 2024, corporations can maintain their margins while offering moderately elevated nominal wage compensation growth without significantly increasing their selling prices.

We estimate that corporate margins (measured by gross operating surplus – GOS) would need to grow slightly less than 3% in nominal terms in 2024 to achieve inflation close to 2.3%, aligning with the Fed's target. This would represent a 0.8pp reduction from the pre-pandemic average and only a 0.3pp drop in the corporate margin rate (GOS over value-added), a feasibly task. The latest available data on the difference between the PMI selling and input price index (a crude proxy for corporate margins) suggests that corporate margins weakened towards the end of 2023, indicating that the ''divine'' combination of reduced margins growth and elevated wage growth is consistent with a return of inflation below 2.5% in 2024.

Taiwan elections – cross-strait tensions remain top-of-mind

The Taiwanese presidential and legislative elections will take place on 13 January 2024. The three main parties in the current Taiwanese political landscape are competing:

- The Democratic Progressive Party (DPP), led by outgoing President Tsai, currently hold a majority in Parliament, with a more China-skeptical stance;
- The Kuomintang (KMT), the historically dominant party advocates for the cross-strait status quo and is perceived as more friendly to China;
- The Taiwan People's Party (TPP), which was established in 2019 to find a middle-ground between the DPP and KMT.

The latest polls indicate that the DPP candidate Lai Ching-te (currently vice president) leads in the presidential race, although the margin over KMT candidate Hou Yu-ih has narrowed. In the legislative elections, opposition parties KMT and TPP are cooperating to secure more seats and potentially snatch the majority from the DPP. After eight years in power, voter dissatisfaction with the DPP is noticeable, especially in the context of slower economic growth and rising living costs.

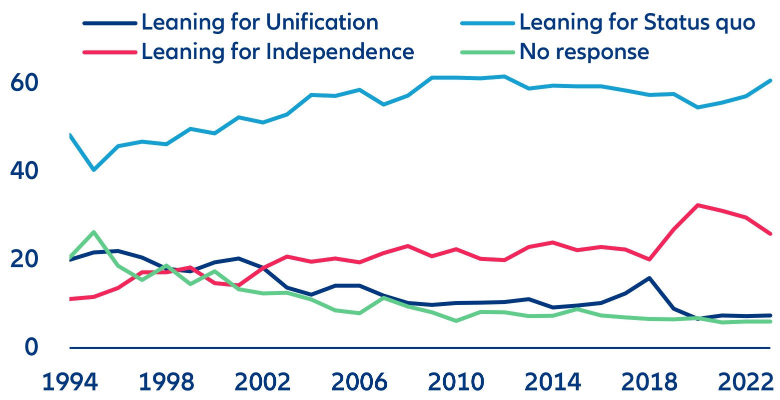
What is at stake? The relationship with China, US-China tensions and global supply chains. While all presidential candidates officially support a cross-strait status quo, a continued DPP government could lead to further economic pressure from China, given the rising tensions between the two sides over the past years. China severed official communications with Taiwanese authorities after President Tsai was elected in 2016. This was due to the DPP's

[3] We deflate by the GDP deflator.

refusal to recognize the 1992 Consensus,[4] a precondition for cross-strait dialogue, according to China. China has adopted a firmer diplomatic stance in recent years, in part driven by intensifying rivalry with the US. The disagreement over Taiwan's status can also catalyze further tensions between China and the US. Beyond geopolitics, Taiwan also holds a systemic position in global supply chains. It concentrates more than 20% of the world's chip manufacturing capacity, produces 60% of global semiconductors and manufactures more than 90% of the most advanced ones.

The baseline scenario: DPP retains the presidency but loses its parliamentary majority, resulting in contained cross-strait tensions (at least in the short term). Recent polls suggest that DPP candidate Lai is poised to win the presidential election. However, his China-skeptical stance may be moderated – at least in the short term – by the opposition parties (KMT and TPP) securing a parliamentary majority. With more seats, the opposition will likely push for a more conciliatory approach towards China. Therefore, in the short term, we anticipate the continuation of the cross-strait status quo with negligible impacts on businesses and financial markets. The medium-term path retains a degree of uncertainty, depending on the level of collaboration between the government and opposition, and factors external to Taiwan. It is crucial to note that the majority of the Taiwanese population favors maintaining the status quo in their relationship with China, with 60% of respondents supporting this stance according to the latest opinion poll (see Figure 6). In our baseline scenario, we expect major escalations in cross-strait tensions to be avoided, and the Taiwanese economy to grow by +2.8% in 2024 and +2.6% in 2025.

Figure 6: Opinion poll regarding Taiwan's relationship with China



Note: we have regrouped answers of the original survey as follows:

- *Leaning for Unification = Unification as soon as possible + Maintain status quo, move toward unification.*
- *Leaning for Status quo = Maintain status quo indefinitely + Maintain status quo, decide at later date.*
- *Leaning for Independence = Independence as soon as possible + Maintain status quo, move toward independence.*

Sources: National Chengchi University, Allianz Research

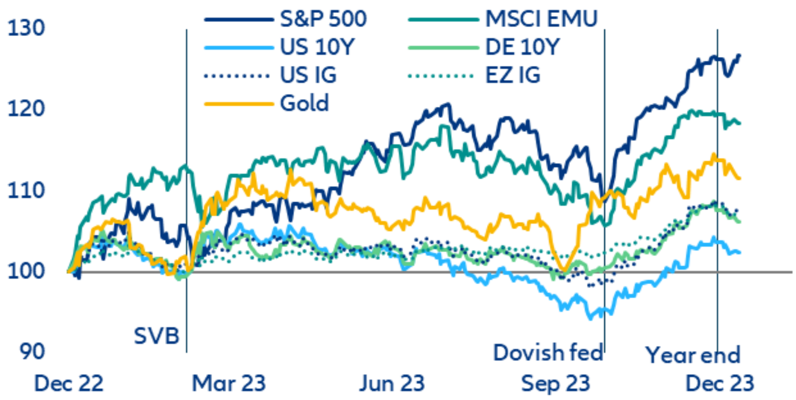
In the medium term, cross-strait relations are likely to remain in a state of contentious equilibrium. The next crucial date to watch is the US elections in November 2024. A clear bipartisan consensus exists in the US regarding skepticism towards China, and the election outcome this November is unlikely to change the geopolitical rivalry between the US and China. However, the different communication styles of US presidential candidates may influence perceptions of geopolitical tensions and potentially increase the risk of unintended incidents. A more confrontational and unconventional foreign policy approach is more likely to provoke China, with potential repercussions for Taiwan and beyond. Further visits by high-ranking US officials also carry escalation risks, as illustrated by Nancy Pelosi's visit to Taiwan in 2022, which prompted China to respond with increased military maneuvers.

[4] An understanding by which there is only "one China," with different interpretations on both sides of the strait to what this means.

Everything higher all at once – what the strong market rally at the end of 2023 means for 2024

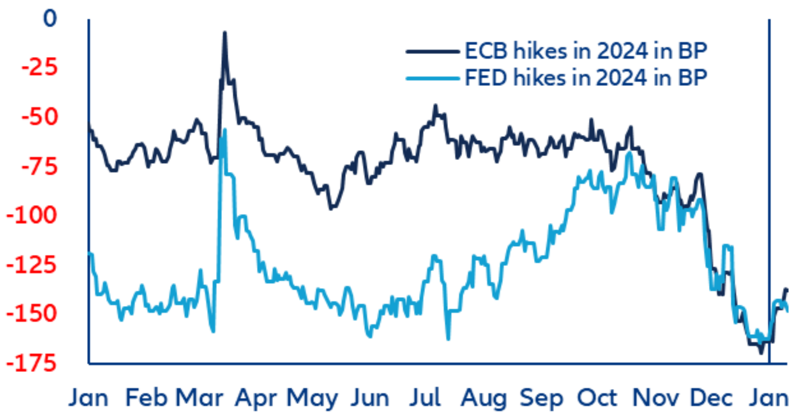
The year 2023 ended with a strong rally in almost all asset classes, driven by optimism surrounding the prospect of faster rate cuts. This remarkable market rally in the last quarter of 2023 helped most asset classes to deliver above average returns for the year. In the US, the S&P 500 recorded an impressive total return of 26% in 2023. Even in the Eurozone, where the economy was much weaker, the MSCI EMU index managed a solid 18% gain (see Figure 7). Bond investors secured positive returns, too, despite central banks raising rates ranging from 100 BP (Fed) to 200 BP (ECB) in 2023. The rapid improvement in market sentiment during the last quarter can be attributed to a series of dovish central bank meetings amid an unexpectedly rapid disinflation trend on both sides of the Atlantic. These developments challenged the prevailing "higher-for-longer" narrative that had dominated markets last summer. Consequently, a substantial amount of additional rate cuts was priced in for 2024 (see Figure 8) which was embraced by bond and equity markets but also alternative assets: Gold surged by 13%, and Bitcoin posted a remarkable 56% increase just in the final quarter of 2023.

Figure 7: Total returns of different asset classes in 2023



Sources: LSEG Datastream, Bloomberg, Allianz Research.

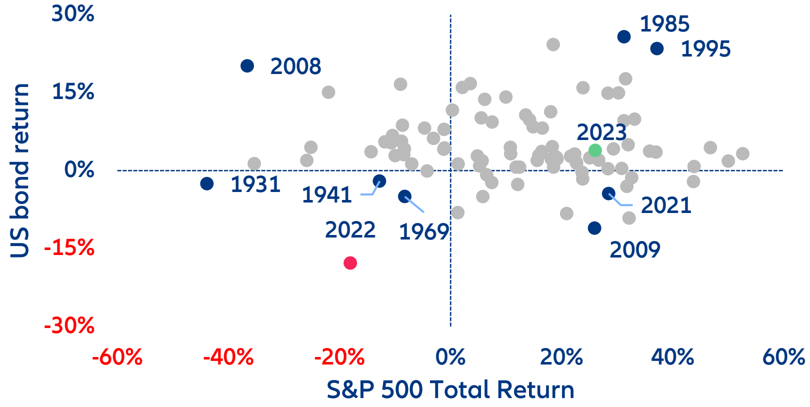
Figure 8: Market pricing of interest rate cuts in 2024



Sources: LSEG Datastream, Bloomberg, Allianz Research.

Bond-equity correlations were again positive in 2023 but this time returns have been in the "good" quadrant. After a challenging 2022 for the 60-40 portfolio[5], 2023 marked a significant shift. Despite some bumps along the way, equities took the lead in driving investment returns – a cornerstone of the 60-40 strategy.[6] Bond-equity correlations turned negative due to global banking crisis fears in March. Bonds provided a lifeline by offering positive returns (due to a downward adjustment of interest rates), cushioning the impact of the equity market correction. Had this trend persisted, we would have faced a situation reminiscent of 2008 (see Figure 9), underscoring the hedging role of bonds in the 60-40 strategy. However, mid-summer brought a different challenge as expectations of "higher for longer" interest rates led to losses across all asset classes, erasing diversification benefits and echoing the difficulties of 2022. The "everything rally" in the last quarter of 2023 left the sign of cross-asset correlation positive, positioning returns for bonds and equities in the "good" quadrant (See Figure 9). While we anticipate positive correlations to continue in 2024, returns are expected to be narrower.

Figure 9: Bond-equity correlations in the US



Sources: NY University, LSEG Datastream, Allianz Research. US 10Y used for bond returns.

Valuations seem stretched and the first weeks of 2024 already witnessed a repricing of market euphoria. Our fair value models for 10-year government bond yields indicate that the rally may have gone too far for both US Treasuries and German Bunds. In the US, the fair level of 10-year treasury yields continued to rise at the end of 2023, driven by less favorable supply and demand dynamics amid high bond issuance, coupled with ongoing quantitative tightening by the Fed (see Figure 10). However, the simultaneous drop in actual 10-year yields from almost 5% in October to below 4% at year-end appears to have undershot valuations. Equity markets also show signs of stretched valuations, particularly in the US (see Figure 11). This apparent tight valuation is even more remarkable when considering that safer assets now offer more attractive yields compared to some years ago. As a result, the equity risk premium in the US has reached extremely low levels. Nonetheless, the outlook for equities in 2024 remains positive, although less pronounced than in 2023, with expectations of single digit total returns around 4% in Europe and 6% in the US. While we acknowledge the vulnerability of the US equity market due to its high concentration of aggressively priced tech firms, we believe it's likely to outperform European markets in 2024. Although euphoria around AI may be overdone at this early stage, US companies seem better positioned to capitalize on a theme that will shape the corporate landscape. In contrast, European stocks, while appearing more reasonably valued by conventional metrics, face other vulnerabilities, including an ongoing struggle with economic growth and higher susceptibility to geopolitical tensions (particularly those linked to Ukraine and the Middle East – see our story on the Red Sea crisis). Overall, tight valuations leave both asset classes, bonds and equities, exposed to a less-optimistic repricing of monetary policy paths, setting the stage for a potentially volatile 2024.

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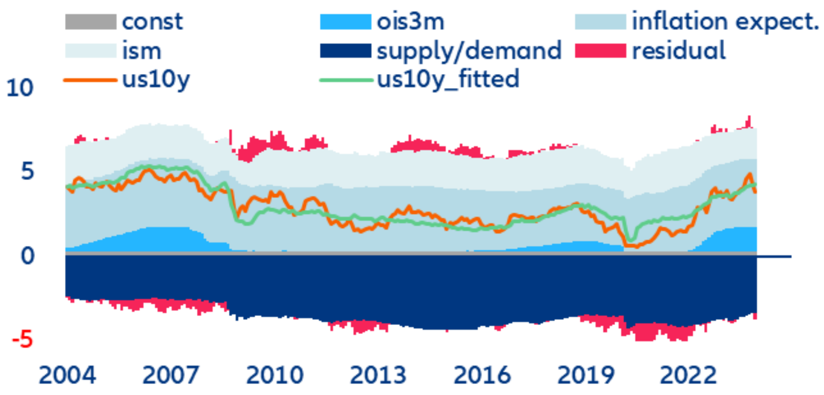
5 A 60-40 portfolio refers to a balanced portfolio of 60% equities and 40% bonds which has usually profited over long time horizons by offering a better risk/return profile due to negative correlations between bonds and equities.

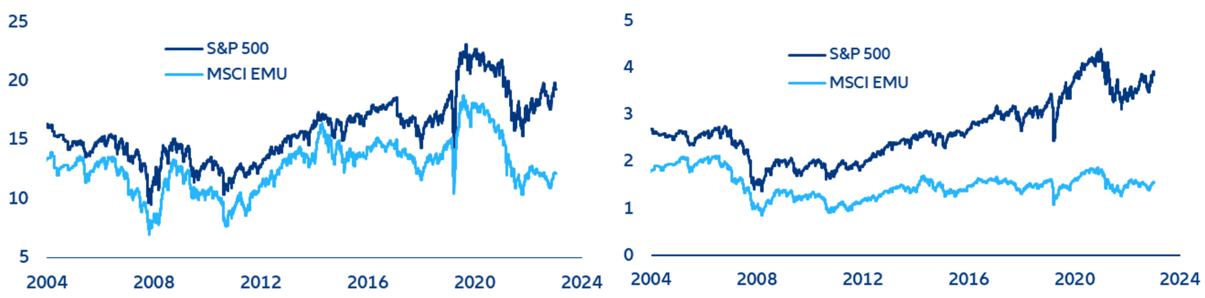
6 Find our deep dive on portfolio diversification and deeper historical analysis here: Is diversification dead? (allianz.com)

Figure 10: Fair-value US 10y yield model



Sources: LSEG Datastream, Allianz Research.
Notes: The chart shows contributions to the fair value estimate of the US 10y yield based on a cointegration model using four variables: Overnight Index Swap (3 months) as a proxy for the monetary policy stance, ISM Manufacturing as a proxy for the current cyclical state of the economy, Michigan University long term inflation expectations and a bond demand/supply metric expressing the share of US treasuries held by rate in-sensitive investors like the Fed through its QE program and overseas state funds and central banks.

Figure 11: 12M forward price-to-earnings (left) and 12M forward price-to-book value (right)



Sources: LSEG Datastream, IBES estimates, Allianz Research.

These assessments are, as always, subject to the disclaimer provided below.

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