Year Ahead 2023

Tomorrow Begins Today

NatWest

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Welcome to the Year Ahead

John Briggs
Global Head of Economics and Markets Strategy

Energy Holds the Balance of Power

Coming into 2022, our focus – and that of global markets – was squarely on the shape of the post-pandemic economy.

Businesses and investors faced a world of shortages and tectonic shifts in central bank decision-making. Governments grappled with how quickly to pull on the fiscal levers and allow consumers to regain their pole position as the engine of growth. All of this led us to argue at the time that shortages and supply chain disruptions would persist, causing central banks to be even more hawkish – and that both of these factors would drive markets to a far greater degree than most appreciated.

Looking back, it seems as though even we may have underestimated just how influential these factors have been for markets and the global economy. As an untameable virus gave way to untameable inflation, tightening the screws on global policymakers, markets saw (and continue to see) a fair share of fits and dizzy spells, all exacerbated by the war in Ukraine. From goods to services to labour and, perhaps most acutely, to energy, the supply side of the economy has rarely been so disrupted, or indeed disruptive to the outlook.

It is the last of these – energy – that commands our attention this time around. Lower energy prices in 2023 could provide a path for a global economic soft landing by insulating consumers and businesses from the most detrimental of cost increases; it could dissuade inflation-targeting central banks from keeping interest rates prohibitively high for longer. Sustained higher energy prices, on the other hand, would result in ongoing stagflationary risks to the global economy and tighter monetary policy for longer, sapping consumption and business investment – including into the energy sector itself.

Naturally, many variables will determine the course of the world in 2023. But we expect the outlook for energy to be a significant, possibly dominant, factor. That's why it's core to the four key themes we explore in the Year Ahead 2023:

1. Finding the Energy: The Outlook for 2023
2. Moving Beyond Gas-Fired Inflation: Prices & Monetary Policy in 2023
3. Fuelling the Fire: Geopolitics in 2023
4. Restarting the Energy Transition: The Nuclear Option

As we look ahead to 2023, the challenges facing the global economy are daunting but not insurmountable. In these pages, we lay out our views on how key themes will shape markets and the economy, fully anticipating that the outlook will present not just unforeseen challenges, but also opportunities. We look forward to working with you as a partner to understand, analyze, and thrive through a period of uncertainty.

John Briggs

Energy Holds the Balance of Power

Four energy related issues to drive 2023

Energy and its impact on the businesses, consumers, investors, policymakers, and the geopolitical landscape rose to the fore in 2022. So as we enter 2023, the future path of energy will have a major impact on global economies, central banks, corporations, and governments. We take a look at four energy related themes to set the table for our regional and country specific outlooks, including an overall outlook for energy itself in the coming year.

Running on empty: what's in store for energy markets in 2023

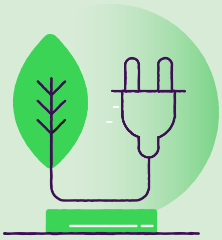
The macro backdrop for energy markets has weakened as global growth expectations have ebbed, but from a more micro perspective a fundamental mismatch of supply and demand remains.

Listen to the podcast on **Apple Podcasts** or **Spotify**

Restarting the green energy transition in 2023: the nuclear option

Renewables remain an integral part of the sustainability journey, but what is the appropriate role for nuclear, one the cleanest and most efficient energy sources? We explore some of the reasons why it remains so controversial, the steps some countries have already taken and the prospect for major investments in the sector.

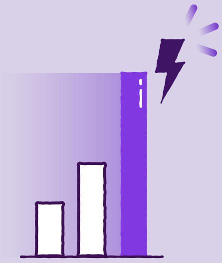
Listen to the podcast on **Apple Podcasts** or **Spotify**



Moving beyond gas-fired inflation: prices & monetary policy in 2023

Energy base effects will bring about a sizeable reduction in inflation in the major economies in 2023 but stickiness in core components (much of this stemming from tight labour markets) will prevent an early dovish policy 'pivot' by central banks.

Listen to the podcast on **Apple Podcasts** or **Spotify**



Fuelling the fire: the biggest geopolitical risks to look out for in 2023

Without question geopolitics became a major risk in 2022, and we expect that risk to rise further in 2023, and with those risks emanating from many parts of the world. A discussion with Scott Livingstone, NatWest's International Advisor, only reinforces that view.

Listen to the podcast on **Apple Podcasts** or **Spotify**

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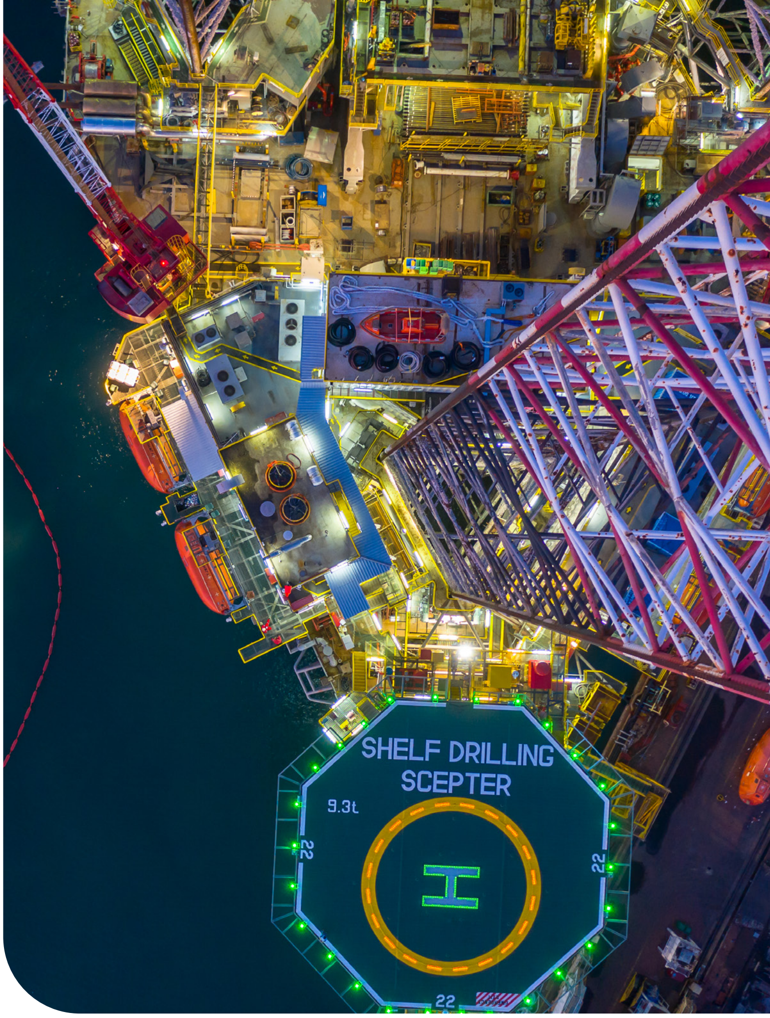
For any terms used, please refer to this glossary

Running on empty: what's in store for energy markets in 2023

Energy prices have rocketed in 2022, mainly due to the war in Ukraine. But with the global economy slowing down, can we expect similar rises in the year ahead?



The macro backdrop for energy markets has weakened as global growth expectations have ebbed, but a fundamental mismatch of supply and demand remains. Our specialists consider the various factors that are likely to drive developments in energy markets in 2023.

Brian Daingerfield
Head of G10 FX Strategy, US

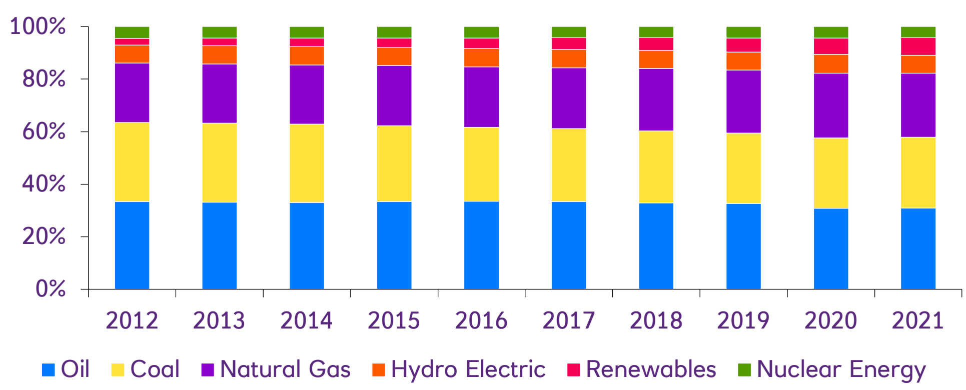
Energy demand slowdown will weigh on investment

NatWest economists expect major economies to enter recession next year, and the impact of softening growth expectations combined with rising interest rates is set to filter through into global energy demand.

The International Energy Agency (IEA), for example, expects global oil markets to be roughly balanced through 2023, while OPEC recently revised its estimate for global oil demand downwards.

A slowdown in demand may reduce the likelihood of increased energy production to restock low global inventories, despite high prices. Investment and production in both OPEC and non-OPEC nations has lagged the recovery in demand, and they are unlikely to catch up in the current softer-demand environment.

Global energy use by primary source (2021)
Source: British Petroleum 2022 Statistical Review of World Energy



Opportunities to switch energy sources

One source of demand for oil, regardless of the macro environment, is the drive amongst consumers, manufacturers, and power producers to switch sources. We expect switching activity to remain generally supportive of oil prices as oil remains attractive relative to natural gas in terms of cost.

Another potential beneficiary of high natural gas prices are renewables. Recent price movements and climate-related investments, such as those set out in 2022's Inflation Reduction Act in the US, look likely to result in increased use of renewables in electricity generation.

"Another potential beneficiary of high natural gas prices are renewables."

OPEC+ will likely stay the course on production cuts

After months of steady increases in oil production quotas, in October OPEC+ announced that it would reduce oil production quotas by 2 million barrels per day (mb/d). This was much its largest production cut since the depths of the pandemic and represented a major shift in the group's strategy. By slashing oil production quotas, OPEC+ was signalling its intention to prevent oil prices from falling much further. We think it is unlikely that demand expectations will recover to the point where OPEC+ will increase production quotas in 2023.

Of course, the outlook for OPEC+ in 2023 is inexorably linked to its largest two members: Saudi Arabia and Russia. The OPEC+ partnership spearheaded by these two nations has survived several previous periods of significant market stress, and our base case is that their cooperation will continue through 2023. A breakdown in the partnership would be a bearish development for crude prices, should it occur, as it would imply an "every nation for itself" approach and further reduce OPEC+'s ability to influence market balances and prices.

A persistent decline in Europe's use of Russian energy

The Russia-Ukraine conflict will inevitably evolve in unpredictable ways, but one important question for 2023 and beyond will be the role of Russian oil and gas in the global economy. Can European energy markets ever return to the pre-war status quo, even in a very optimistic scenario?

"We doubt that European energy markets will ever return to the pre-war status quo."

We doubt it. Europe has taken painful, and expensive, steps to secure alternative sources of energy. European natural gas storage capacity, for example, has been expanded and stores are fuller than is normal at this point in the year. Meanwhile, governments across Europe have announced strategies to reduce energy demand.

We think the Western transition away from dependency on Russian energy is likely to remain a theme throughout 2023, with a full EU embargo of Russian seaborne crude oil imports set to come into effect on 5 December and a further embargo of refined petroleum product imports due to come into force on 5 February. The IEA recently estimated that such bans could take another 1.4 mb/d of Russian crude oil and 1.0 mb/d of Russian refined product exports out of the European market.

Unlikely that Iranian oil will return to the market

We have long been pessimistic about a revival of the Joint Comprehensive Plan of Action, otherwise known as the Iran nuclear deal, as many of the core issues hampering talks between Iran and the West are still very much unresolved. The timing of sanctions relief remains a particular sticking point between the two sides. Iran wants sanction relief secured immediately upon the US's re-entry into the deal, or earlier, whereas the US is unwilling to grant sanctions relief until it sees evidence of Iran's compliance with the deal.

Our approach towards Iranian oil in 2023, as in 2022, is that we'll only believe a deal will be struck when we see it. A completed deal could increase supply by as much as 2 mb/d. The risk of an Iranian deal adding fresh barrels to the global markets contributed to OPEC+'s conservative approach to reviving oil production throughout the recovery from the pandemic. With OPEC+'s strategy now focused on defending prices, the group may prove more willing to actively cut supplies should a revived Iranian deal bring oil back to the market faster than expected.

A mixed outlook for US oil supply

In 2022, non-OPEC producers faced a trade-off between production and investment. The recovery in near-term demand and surge in prices created a strong incentive to produce and capitalise on stronger economic conditions. But long-term challenges for the fossil fuel industry remained a headwind for investment and production. ESG considerations and the global energy transition to cleaner alternatives also represent major question marks overhanging the long-term future of fossil fuel production.

In 2023, these factors may no longer act strictly in conflict. Instead, they may increasingly work in concert as an expected slowdown in demand is likely to influence future investment decisions and production growth.

This is not to say that we think US production is set to contract in 2023. There is still a clear incentive for US production in the form of both high prices and increased export capacity, particularly to Europe. But the headwinds facing the industry in the form of a slowdown in expected demand, increased regulatory scrutiny and more difficult access to capital may prevent production from reaching its pre-pandemic heights in 2023.

The US remains a seller – for now

One source of commercial inventory "growth" in 2022 came from storage facilities rather than from the ground as authorities (particularly those in the US) released significant amounts of oil from emergency stockpiles. We expect the Biden administration to remain aggressive in terms of reducing the Strategic Petroleum Reserve (SPR) in an effort to combat high energy prices.

But that does not mean the US will only sell from its SPR in 2023. The Biden administration has already announced plans to begin buying oil again next year to restock the SPR at a price target of around $70 / barrel. Expectations of purchases to eventually refill the storage facilities of the US and those of its IEA allies that have also released emergency stockpiles may limit downward pressure for oil prices in 2023, as potentially large buyers are lurking should prices drop further.

ESG and the global energy transition

From an oil and gas production perspective, we think it is too simplistic to suggest that the relatively slow investment in oil and gas extraction since the pandemic is purely a function of ESG-related issues.

That said, private investor demand for investment in clean energy alternatives coupled with public sector pressure on energy production is likely, in our view, to be a theme that overhangs global energy markets over the next decade and beyond. For a deep dive on this, listen to our Year Ahead podcast on how energy market shocks could affect the transition to a green economy.

Restarting the green energy transition in 2023: the nuclear option

Eye-watering energy prices and sweltering temperatures have led to a renewed focus on the transition to a greener energy mix. We think 2023 could see nuclear energy take greater prominence in that discussion.

Alvaro Vivanco
Head of EM and ESG Macro Strategy

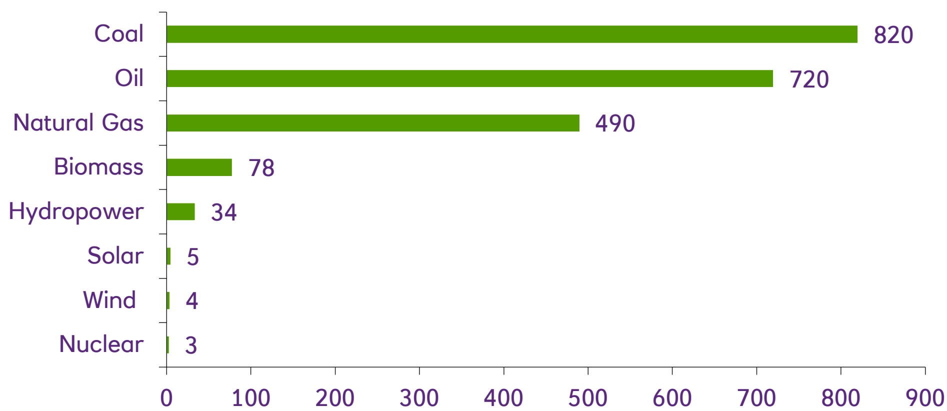
Will higher energy costs amid already high inflation delay, or potentially kill, the energy transition? Will countries be capable of balancing the short-term energy crunch with their long-term emissions reduction goals? We expect these questions to be at the centre of the ESG (environmental, social, and governance) debate in 2023.

Against a backdrop of high energy prices, some countries are reverting to emissions-intensive energy sources in order to secure supplies. But what about the long term?

Nuclear energy accounts for a tiny fraction of the global energy mix

The role of nuclear has taken on a more prominent role in discussions about a future, greener, energy mix. Nuclear energy is much cleaner from a carbon emissions perspective than other sources of power: it produces around three tons of greenhouse emissions per GW/hr of electricity, compared with 820 tons for coal, 720 tons for oil and 490 tons for natural gas. It even produces less emissions than solar and wind. What's more, new, advanced reactors produce energy more securely, reliably, and cost-effectively than before.

Nuclear energy is by far the cleanest available technology (tons of greenhouse gas emissions per gigawatt-hour of electricity)
Sources: NatWest Markets, Our World in Data



However, as of 2021, nuclear energy accounted for just 4% of global energy production – well behind oil, which accounted for close to a third of the total, natural gas, and coal. In fact, there are only a few countries where nuclear makes up a significant share of the energy mix. North America uses less nuclear power than Europe, while the share of solar and wind has gradually increased over the years and surpassed that of nuclear in 2017.

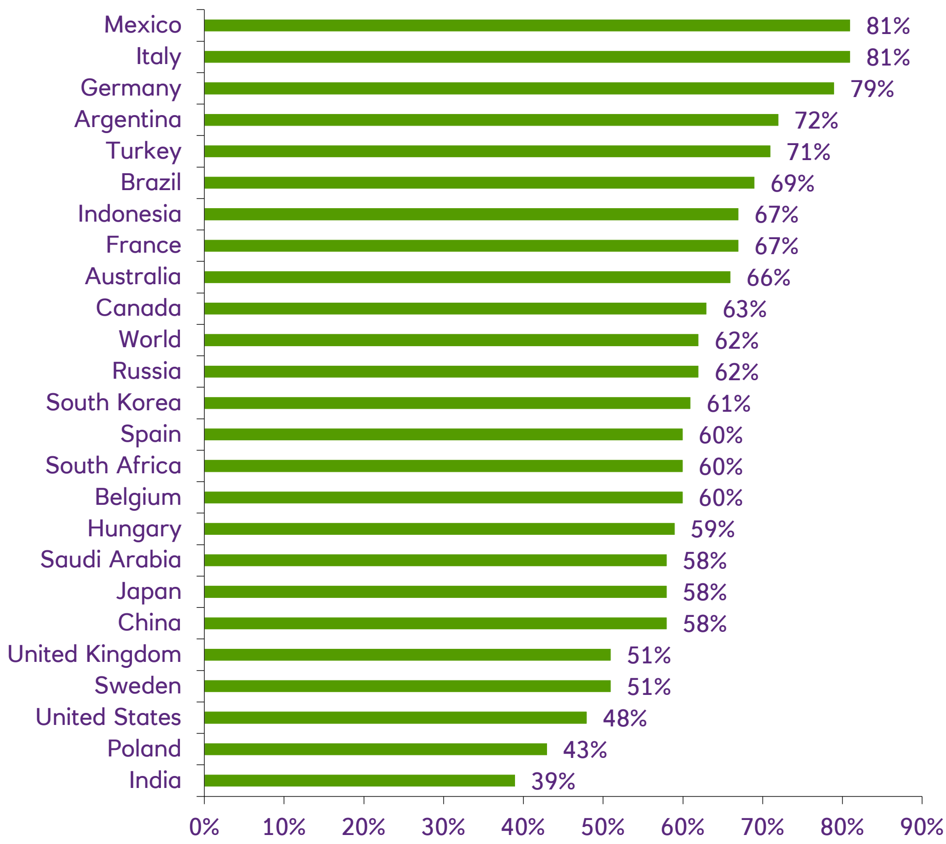
Given their cost advantage, renewables will continue to play a critical role in the energy transition. But why does nuclear represent such a marginal source of global production? We think the main problems it faces are public concerns about its safety, high costs, a lack of political will and, ultimately, not enough investment.

Nuclear and renewables are far safer than fossil fuels

Nuclear energy has a much better safety record than fossil fuels, which cause many more fatalities than nuclear and modern renewables per unit of electricity produced – around 1000 times more in the case of brown coal. If we consider deaths linked to air pollution, mortality rates from fossil fuels are likely to be even higher. Meanwhile, spent fuel, the main by-product of nuclear energy, is safely and securely stored at multiple reactor sites across the globe.

Safety, though, remains at the core of the negative perception of nuclear. Historically low frequency, but highly visible, events such as Fukushima and Chernobyl have had a big impact on the public's view of nuclear as a viable long-term source of energy.

Public opposition to nuclear energy production (% of IPSOS MORI survey respondents)
Sources: NatWest Markets, IPSOS MORI, Our World in Data



Efforts to harness nuclear's potential are starting to increase

The recent global energy crunch has reignited the debate about the role of nuclear as a reliable source of power that produces limited carbon emissions; and it has led to a number of countries making concrete plans to increase their use:

- In the UK, the Energy Security Strategy published in April set out new ambitions for nuclear energy. The strategy would see nuclear capacity of up to 24 GW by 2050, representing around 25% of projected electricity demand, up from 15% in 2022. Eight reactors would be built with the help of a new government body, Great British Nuclear, to speed up what has traditionally been a slow process.

- In February, France announced plans to build six large new reactors starting in 2028 and eight more by 2050.
- Poland has ramped up agreements and partnerships with countries beyond Europe, including the US, to build nuclear energy capabilities across the country.
- In the US, the Inflation Reduction Act complements the CHIPS Act's acceleration of nuclear by including several tax credits and incentives to support the potential deployment of advanced reactors. The legislation also includes $700 million for the Office of Nuclear Energy to support the development of a domestic supply chain for uranium.
- Japan has restarted its nuclear reactors (they were all closed down after the Fukushima accident) and is looking to develop next-generation reactors that will be safer and more efficient.
- In July, South Korea's government laid out its New Energy Policy Direction, which aims to ensure nuclear accounts for a minimum of 30% of the country's energy mix by 2030. It is also resuming the construction of two units at existing nuclear plants.

Meanwhile, nuclear technology is developing quickly. More than 20 companies in the US are currently developing advanced reactors that will completely change the way we think about the nuclear industry. Most of these new reactors will be smaller, more flexible, and less expensive to build and operate. They can be used to power hospitals or other service centres on an exclusive basis and, if used appropriately, have the potential to reduce energy reliance on countries like Russia.

More investment in nuclear energy could help develop the sector

Nuclear has great potential, but it is also expensive to build new nuclear power plants. In order to reach global net zero targets and diversify the energy mix, major investments are needed and new forms of support for technological breakthroughs need to be pursued.

Thus far, investment in nuclear has been miniscule compared with the amount of money flowing into traditional renewables and related areas such as electrified transport. This is despite the considerable benefits that nuclear power provides, both in efficiency and emissions terms.

"In order to reach global net zero targets and diversify the energy mix, major investments are needed."

How will the nuclear debate evolve in 2023?

In addition to the two primary challenges that we referred to – high costs and social perception barriers – increased adoption of nuclear in 2023 could be stymied by the move towards renewable alternatives. The relatively attractive prices of solar and wind power represent a significant feature of the green transition. And the arguments in favour of nuclear become less compelling when we factor in that management and engineering teams are scarce and nuclear power plant construction projects are running significantly behind schedule.

While decarbonisation plans have not been explicitly shelved this year, the recent focus for governments has been on dealing with more immediate priorities such as safeguarding energy security, job stability, low prices, and the smooth functioning of economies.

How nuclear could grow

In our view, several developments are needed if nuclear is to play a bigger role in the global energy transition. Small, advanced reactors must become more prominent as their flexibility and practicality is not yet being fully exploited. Supply chain fluidity has to improve, and public perception about safety must be properly addressed: this requires public campaigns about nuclear's safety track record and the benefits that come with technological improvement.

What's more, governments should see nuclear not just as a solution to their climate transition plans. It is important for them to focus on using local resources and meeting their domestic population's needs in order to build a sustainable, secure energy system. We believe that nuclear has an important role to play in the transition to a greener economy.

"We believe that nuclear has an important role to play in the transition to a greener economy."

Moving beyond gas-fired inflation: prices & monetary policy in 2023

An untameable virus has given way to untameable inflation, but how will policymakers manage to balance prices and economic growth in the year ahead? Ross Walker, Kevin Cummins, and Giovanni Zanni share their views

It's clear that 2022 was another extraordinary year, with inflation hitting levels far in excess of expectations. It's currently hovering around 8–11% in the US, UK and eurozone.

Quick recap: what's been driving inflation in 2022?

Energy prices are directly responsible for around a third of the current bout of inflation. Food is also making a major contribution, such that the 'non-core' (food and energy) component accounts for roughly half of current inflation levels. Services inflation is running above longer-run averages, but to nothing like the same extent as energy, food, and goods inflation. What's more, some of the increase in services prices stems directly from higher energy costs.

The other main driver of inflation has been higher global goods prices. Trends in this area are inevitably complex. There is a basic energy and commodity cost dimension, which is now beginning to slowly moderate. Issues with global supply chains have also played a part, but pressure here too appears to be easing. Some high-profile components (such as second-hand car prices) are now moderating, but there is still a general stickiness in goods prices.

Where will inflation head in 2023?

Inflation is forecast to fall in 2023 – albeit from very elevated levels – due to large energy price base effects. Nevertheless, we expect inflation will still exceed levels targeted by major central banks by the end of 2023, with US core price inflation (CPI) at 3.0%, eurozone inflation at 2.6%, and UK CPI at 4.3%.

By the end of next year, we expect energy's contribution to CPI to have fallen to 10% in the US and UK (from 20% and a third, respectively), and to have largely disappeared in the eurozone. Energy prices falling from a high base will be a necessary – but probably not sufficient – condition for inflation to return to close to target levels.

For year-on-year inflation not to decline in 2023 would require an extraordinary price shock. While energy prices could well rise further over the coming years, it's hard to believe price gains in 2023 will exceed those from this year. So, inflation should fall – but how far, and how quickly?

Ross Walker
Head of Global Economics / Chief UK Economist

Kevin Cummins
Chief US Economist

Giovanni Zanni
Chief Euro Area Economist

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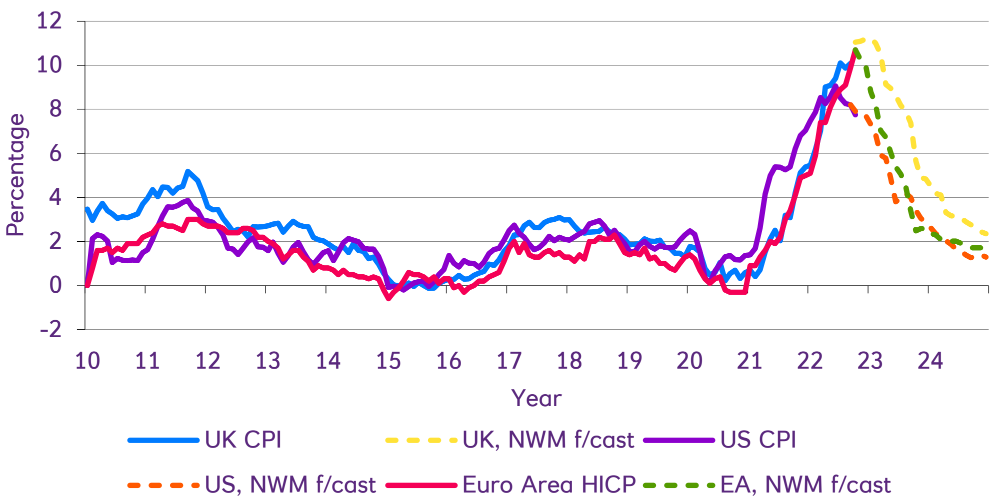
Key inflation forecasts (%)
Sources: NatWest Markets , Markit



> **"Energy prices are directly responsible for around a third of the current bout of inflation."**

Labour markets, energy prices, and sticky prices will be big drivers of CPI

In 2023 we expect tension between the disinflationary effects of recession and the inflationary effects of lagging cost pressures working their way through the system and tight labour markets. Forward-looking indicators tend to emphasise disinflationary pressures, while lagging and current indicators retain a more inflationary feel.

A common feature of our US, eurozone and UK inflation outlooks is a degree of stickiness in core inflation in 2023 and 2024. Energy base effects will tend to reduce headline rates more rapidly than core measures, with the gap between the two narrowing sharply over the course of 2023.

The United States

We see subtly different factors at play in these regions. In the US, core CPI is expected to moderate from 6.3% at the end of 2022 to 3.2% by December 2023, and 2.1% by December 2024. The US dollar's sustained strength is likely to weigh on core goods prices, while on the services side we expect prices to continue to increase (albeit less quickly than before) due to the shelter component.

The key factor likely to lead to sustained inflationary momentum in the US in 2023 is continued tightness in the labour market. In our view, for inflation to eventually get back toward 2% (the US Federal Reserve's target), there needs to be a persistent situation in which there are fewer jobs than workers and somewhat fewer openings than unemployed workers. So far there has been no convincing evidence of wage pressures easing. Against a backdrop of a tight labour market, this will prevent core services inflation from slowing down significantly in 2023.

Eurozone

By contrast, wage pressures in the eurozone remain subdued. We view core inflation in this region less as a gauge of underlying inflation or a leading indicator and more a lagging reflection of energy prices. We expect some pick-up in wage inflation in the eurozone in the coming months, with the key question being whether this is one-off in nature or whether these pressures will persist.

The United Kingdom

In the UK, demand indicators are more subdued than in the US and total hours worked remain 0.6% below pre-pandemic levels. The UK has its own idiosyncrasies – notably a sharp increase in inactivity during and after the pandemic, including a near-400,000, 17.5% increase in those classified as long-term sick.

A key consideration is how permanent the reduction in UK labour supply is – the more permanent, the tighter the labour market and the higher that wage inflation would be expected to be. Conversely, to the extent that the move towards inactivity reverses in response to cost-of-living pressures and a turnaround in sickness trends, the higher the labour market slack in the UK.

> **"A key consideration is how permanent the reduction in UK labour supply is – the more permanent, the higher the inflation."**

What are the implications for central banks and monetary policy?

While central banks could be forgiven for having not foreseen the extent of the energy price shock in 2022, the experience and the criticism they have encountered suggest policymakers will be wary about easing monetary policy soon. To date, there has been no substantial progress in bringing down either inflation or wages. Until measures of inflation clearly reverse, we think it will be difficult for central banks not to continue to raise interest rates.

Although we forecast substantial declines in inflation in 2023, we still expect headline CPI rates to exceed 2% in the US, eurozone and UK at the end of next year. That doesn't preclude interest rate cuts later on in the year, but our base case is still that rate cuts will not materialise until 2024.

The United Kingdom: sterling's weakness a thorn in the Bank of England's side

The Bank of England ramped up its hawkish rhetoric in the aftermath of the UK government's recent tax-cutting Growth Plan, warning of a 'significant' monetary policy response. Policymakers did step up the pace of tightening in November, hiking by 75 basis points to 3.0%, but also cast doubt on the market's pricing of terminal rates of around 5.25%. Sterling's weakness remains a potential problem for an open economy like the UK, with imports accounting for around 30% of the CPI basket. However, there have been some signs the currency is stabilising since the government's fiscal policy U-turn and the changes of prime minister and chancellor.

In short, we believe the Bank of England is unlikely to cut rates in 2023, even in the face of a deepening recession.

The United States: more room for rates to climb

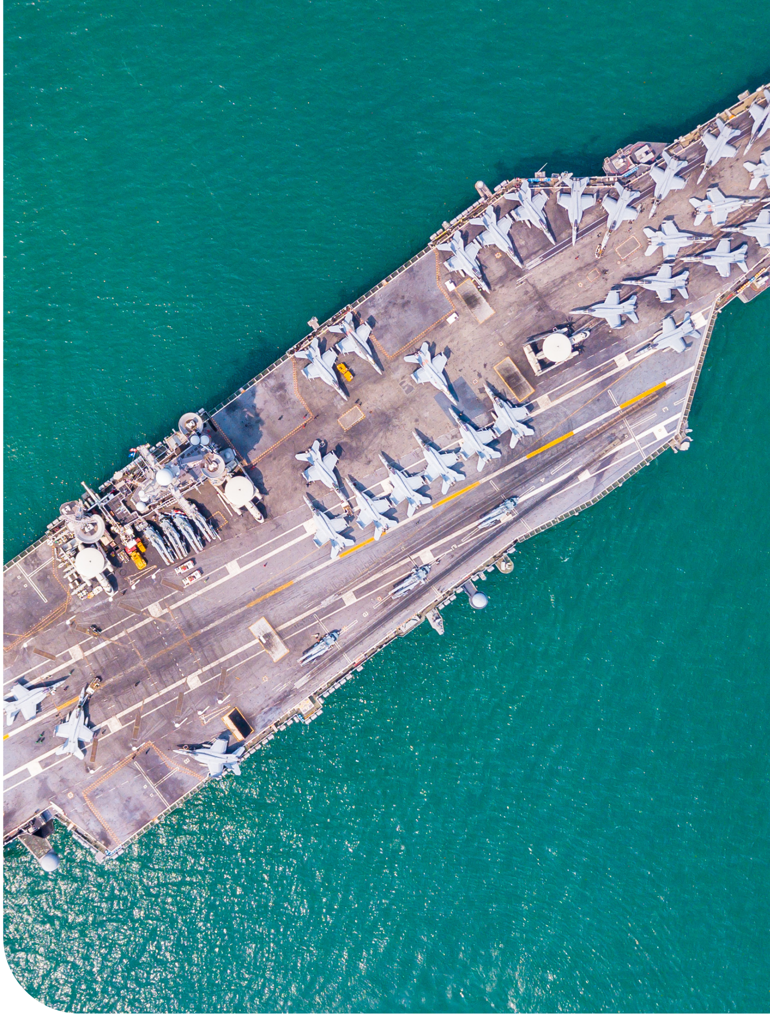
We believe that monetary policy tightening cycles have a little further to run, although there have already been some hints that policymakers are becoming less aggressive. We forecast the Fed Funds rate will climb to a terminal rate of 5.0% in mid-2023, slightly below the 5.1% peak that the market is pricing in.

Eurozone: of the trio, most inclined to keep rate rises contained

Finally, we expect the European Central Bank (ECB) to raise its depo rate to a peak of 2.25% by Q1 and remain at this level throughout 2023. This represents a significantly more dovish (and earlier) outlook for the peak in policy rates than the peak of around 3.0% in Q4 currently priced in by the markets.

Fuelling the fire: the biggest geopolitical risks to look out for in 2023

Geopolitics looks set to be a big driver for markets and the economic outlook in the year ahead.



Geopolitics came to the fore in 2022, primarily in the form of the war in Ukraine. The conflict accentuated the supply-side inflationary pressures facing a global economy already struggling to emerge from the pandemic.

Next year too looks like it could be fraught with geopolitical turbulence, and not just in Ukraine. Here is where Scott Livingstone, International Advisor to NatWest Group, sees the likeliest sources of risk in 2023 across the geopolitical landscape.

Scott Livingstone
International Advisor

War in Ukraine: time is on nobody's side

The balance of power currently resides with the Ukrainian forces, which currently have better morale, momentum, and munitions than the Russian troops. But while Ukraine has the advantage right now, a harsh winter will take its toll. We're entering the prime weeks and months for Russian pressure to take effect, both through restrictions on energy flowing to Europe and the destruction of civilian infrastructure in Ukraine.

"Ukrainian forces, which currently have better morale, momentum, and munitions than the Russian troops."

As we get into the winter, as we see the economic and the energy cost rising in Europe and possibly after the US midterms, we could see an environment more conducive to some kind of off ramp for the crisis. But Putin's actions recently suggest he is not looking for an off-ramp, and evidence of Russian war crimes and increasingly focused attacks on civilian infrastructure do not lay the political groundwork for a peaceful resolution.

Even if there's a peaceful resolution to the war in Ukraine, Russian oil and gas returning to the world market would come with a heavy tax burden. Reparations may also be an issue as the question of who pays to rebuild Ukraine is yet to be answered. There will be conversations in Washington and European capitals about bringing Russian energy back to the market as part of a package that deals with that question.

In the medium term, we cannot rule out a collapse in Russia's capability and forces in Ukraine as its forces struggle with logistics and command and control. My view is that there is no doubt whatsoever that whatever happens in Ukraine, Russia will emerge in a weaker position. And into that vacuum other players, notably China, could step up their regional influence, particularly in Central Asia.

Taiwan: risk of military action?

Tensions are rising between the US and China once again, but don't expect them to escalate into the military realm in 2023. From the US side, it's more likely that we'll see a continuation of the trend of the last six months since Nancy Pelosi visited Taiwan, fuelled partly by anti-China sentiment. And while there's a view in China that the West's influence (cultural, geopolitical, and economic) is waning, China has seen what's happened in Ukraine – that invading a country is very costly and difficult, and that success cannot be guaranteed.

That said, there's a real risk that China will take aggressive action in Taiwan sooner than later. If China were to use its military capability in Taiwan, it would probably be in the form of a comprehensive blockade of the island.

"There's a real risk that China will take aggressive action in Taiwan sooner than later."

Trade war 2.0 and friend-shoring

UK Prime Minister Rishi Sunak is on record as taking a hard line on China and we think that political stance will continue next year. That will probably manifest itself in anxieties about a broader decoupling between China and the West, which will put large commercial entities under pressure as they relocate from China.

We may see more factories moving out as the 'friend-shoring' trend – that is, relocating supply chains to ally countries – continues. There could also be more stringent restrictions applied to exports as the trend towards separation gathers pace.

The rise of Chinese soft power

China will continue to extend its soft power and its commercial and economic clout over many areas of the world that were previously seen as reliable democratic partners of the West. For instance, we saw tensions earlier in the year in the South Pacific, while Saudi Arabia will continue to play off the West against China.

We expect such trends to gain traction, and they could be seen as escalatory by the West as its global influence diminishes. We're already seeing this in some UN votes, such as the one condemning Chinese human rights abuses in Xinjiang. It was defeated because various countries voted with China: a clear indication that its soft power is on the rise.

Iran and the West: rapprochement unlikely in 2023

Iran and the West have a strained relationship, but is rapprochement likely and could Iran return to the energy markets? Right now, Iran's elite is very concerned about the protests about the rights of Iranian women. Their response is to claim the protests are some sort of Western plot rather than authentic discontent from the population. This means the Iranian powers have very little political space to make a deal with the West, and that's not even taking into account that Iran is supplying drones to Russia in its war against Ukraine.

All this suggests the notion of a near-term deal nuclear deal, and therefore Iranian oil coming back onstream, is firmly on the backburner. We can never say never, because the creep towards nuclear weapon capability in Tehran cannot be ignored.

Other geopolitical risks to consider next year

Ukraine-Russia, China-Taiwan and the US-Iran are among the major geopolitical issues right now, but other risks will shape the world in 2023 and beyond, and the biggest of all is climate change. COP27 has shown that the world's leaders have made little progress on cutting carbon emissions since last year's conference. Climate is a geopolitical issue, and unfortunately, geopolitics gets in the way of climate action

Terrorism, too, remains an important risk, even though it is not now dominating our thinking like it did earlier this century. The idea of transnational terrorism, whether from Afghanistan or from West Africa, is debatable, but we need to remember that global terrorist groups have not gone away.

Pakistan is having a very difficult time, dealing with the combined impacts of flooding, political and economic failure, and an unheard-of challenge between civilian and military leaders that is generating a sense of looming instability. This is not helpful in the context of Pakistan's ongoing rivalry with India, and we must remember these two countries are nuclear powers.

Then there is North Korea. We saw provocative missile-firing from the country recently, and most observers are anticipating a first nuclear test in a number of years. The main danger we see here is the unpredictability of the North Korean regime.

After the US midterms, meanwhile, we're waiting to see the direction of US foreign policy and the state of US governance. In all, 2023 promises to be an eventful year from a geopolitical perspective.

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