Q3 2022

GLOBAL MARKET OUTLOOK

FEAR OF THE KNOWN

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Fear of the known

Recession fears and central-bank tightening are driving market volatility. U.S. core inflation has likely peaked, and equity markets are oversold. This should help markets to stabilise and possibly recover over the second half of 2022.

> *The pace and magnitude of U.S. Federal Reserve (Fed) tightening creates the risk of a recession by the second half of 2023.*
>
> **Andrew Pease, Global Head of Investment Strategy**

Introduction

It's been a tough first half of the year, with the MSCI All Country World Index down by 21.7% and the Bloomberg Global Treasury benchmark losing about 9% as of June 17. Markets have faced a laundry list of concerns. These include new COVID-19 lockdowns and an economic slowdown in China, the Russia/Ukraine war, surging inflation and central-bank tightening.

These issues are at least well understood now by markets. At the beginning of the year, it was unclear how far inflation would surge and how aggressively central banks would respond. There was little expectation that Russia would launch a full-scale invasion of Ukraine. The war has now happened, core inflation looks to be peaking in the U.S. and markets are pricing relatively aggressive tightening paths for most central banks.

Our composite sentiment index – which measures investor sentiment for the S&P 500® via a range of technical, positioning and survey indicators – is deeply oversold. This provides some reassurance that markets have accounted for the bad news so far and could recover if inflation and growth turn out better than currently feared.

Of course, it's possible that investors will panic and reach a sell-everything capitulation point. We saw this in March 2020 during the COVID-19 selloff. The lesson from previous market corrections, however, is that periods of panic can provide the best opportunities for longer-term investors.

The main uncertainty is the outlook for the U.S. economy. The pace and magnitude of U.S. Federal Reserve (Fed) tightening creates the risk of a recession by the second half of 2023. A deep recession could trigger a larger equity bear market. We think a slowdown or mild recession are the two most likely outcomes. U.S. household and business balance sheets are in good shape, and these should protect against a more severe downturn.

The upside risk for the U.S. economy and markets comes from the possibility that U.S. core inflation has peaked. This, combined with some softening in the labour market, could allow the Fed to become less hawkish in the second half of the year.

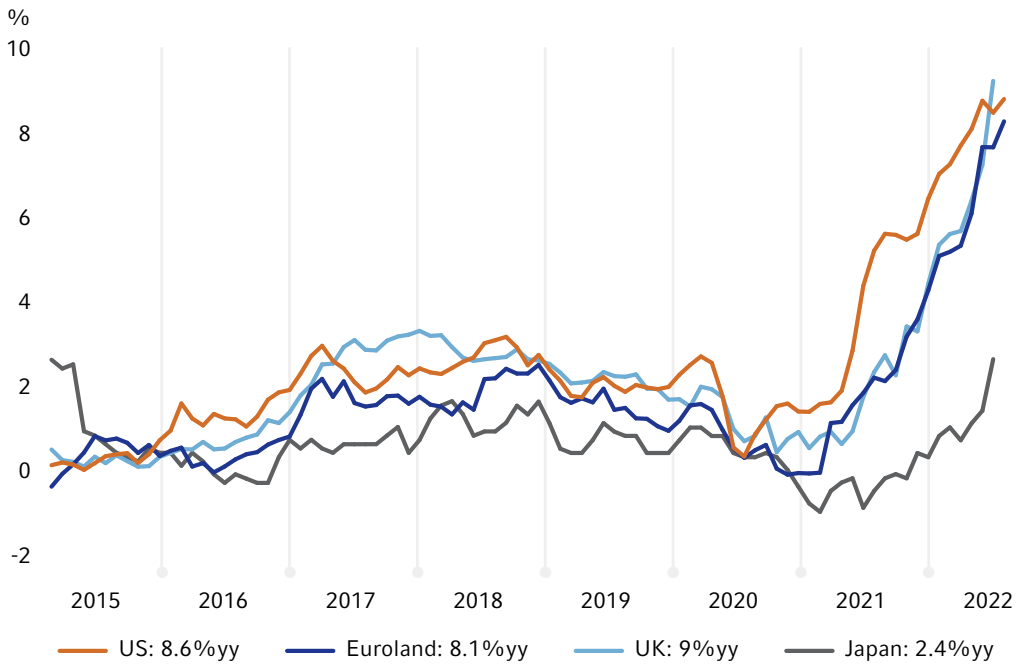
The bottom line is that investors are worried about rising inflation, slowing growth and the potential for an aggressive Fed to cause a severe recession. We think U.S. core inflation can trend lower over the remainder of the year, but the key question is by how much. A sustained move lower would ease fears around excessive Fed tightening and a deep recession. Until this becomes apparent, however, markets are likely to remain volatile.

Nearing peak inflation

Inflation surged during 2021 as demand for goods and services revived when pandemic lockdowns were eased, but supply was restricted by bottlenecks and the slow return of workers to fill open positions.

This year, surging energy prices from the Russia/Ukraine war and further supply-chain disruptions from China's zero-tolerance COVID-19 lockdowns have pushed inflation even higher. In the U.S., the strength of the job market has boosted wages, creating more inflationary pressure.

Global inflation rates



Source: Refinitiv® DataStream®, as of 13 May 2022. YY means the year-over-year difference

Headline inflation may rise further if international sanctions on Russian oil exports cause an additional rise in energy prices. Core inflation, however, which excludes food and energy costs, may have already peaked in the United States.

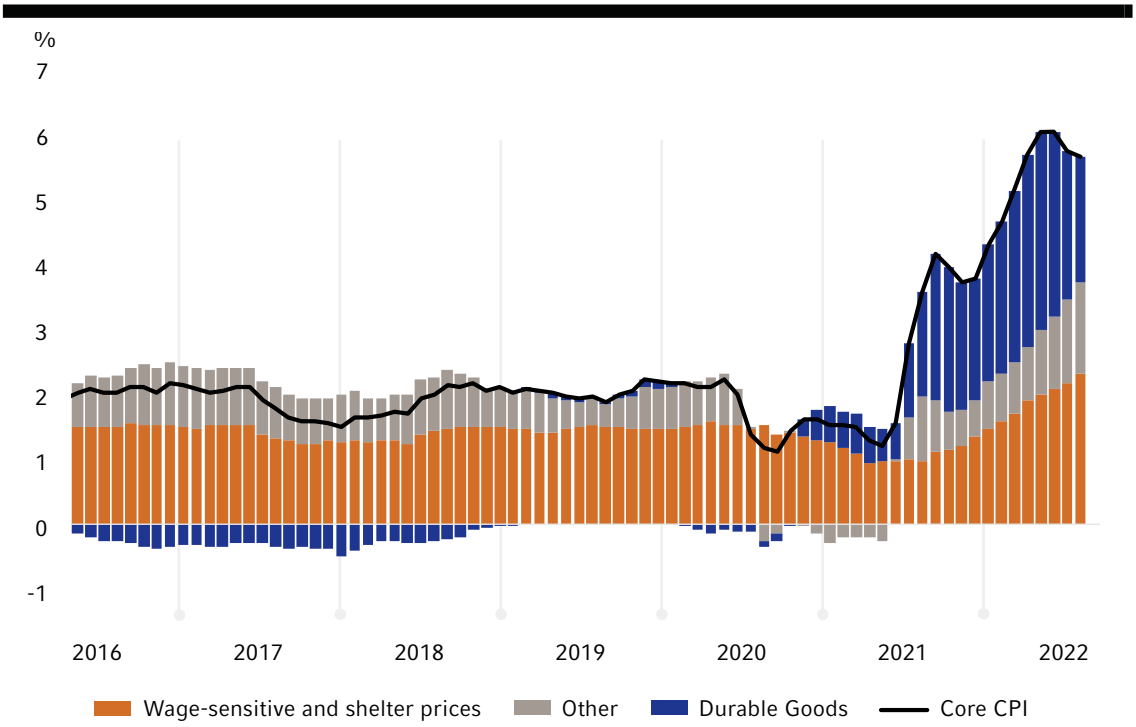
The chart below shows contributions to annual U.S. core inflation. Prices for durable goods, such as automobiles, home appliances and computers, have been the biggest cause of rising core inflation. Demand for these goods shot up during the pandemic while supply-chain blockages restricted supply. Durable goods tended to fall in price before the pandemic and are likely to resume declining as supply chains normalise and demand rotates from goods toward services. Falling goods prices should offset rising services prices and set core inflation on a downward trend.

The issue for the Fed, however, is that inflation tends to be sticky[1] in the wage-sensitive services sectors and for shelter. Core inflation should decline, but potentially not by enough to prevent the Fed from continuing to tighten aggressively. The trajectory of prices in services will largely depend on whether the labour market cools and eases wage pressures.

Some labour-market cooling seems likely. High wages should encourage workers back to the labour force, particularly lower-wage workers who have been the most reluctant to return and have had the largest wage gains. The Fed's shift to higher interest rates should also slow aggregate demand and the labour market. Whether the Fed can succeed in this balancing act will be one of the key watchpoints for the next few months.

[1] Sticky inflation is an undesirable economic situation where there is a combination of stubbornly high inflation (and often stagnant growth). Sticky inflation is often associated with cost-push factors, which cause a rise in the inflation rate but also lead to lower spending and economic growth.

Durable goods have been the biggest cause of rising U.S. core inflation



Source: Refinitiv® DataStream®, as of 15 May 2022. CPI is consumer price index. Chart shows year-over-year % change.

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> **Andrew Pease**

Soft, soft-ish or hard?

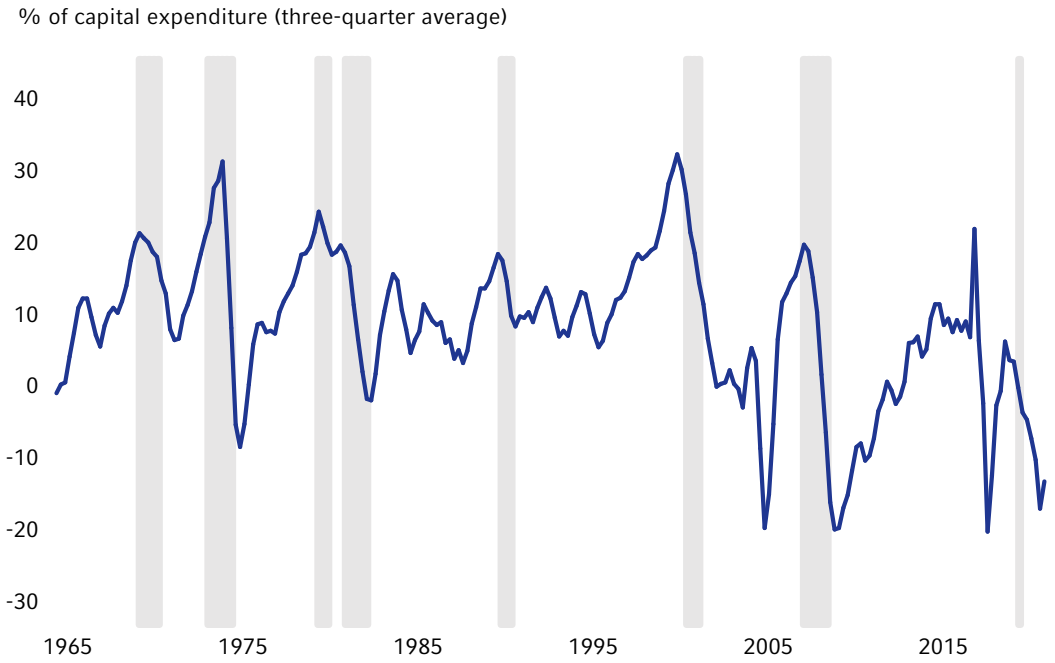
The pace and magnitude of Fed tightening means a U.S. recession by the second half of next year cannot be ruled out. The fixed income market expects the federal funds rate to reach 3.75% by the middle of 2023, which would make it one of the fastest tightening episodes.

Fed chairman Jerome Powell recently argued the Fed has a reasonably good track record of engineering soft landings where recession is avoided, or soft-ish landings where the downturn was mild and short. Of course, the Fed is always going to aim for a soft landing when tightening policy. The Fed might, however, have a shot at avoiding a major recession this time given the lack of significant imbalances in the corporate and household sectors.

Household finances are in good shape. Household debt relative to gross domestic product (GDP) in the U.S. is the lowest in 20 years and households are still sitting on more than $2 trillion of excess savings accumulated during the pandemic.

Corporate finances are also healthy. The chart below shows the corporate financing gap, as taken from the Fed's financial accounts database. The financing gap is the difference between internal funds (mostly retained profits) and capital investment spending. A positive reading means the corporate sector requires external funds, such as debt and new equity, to finance capital expenditures (capex). Every recession in the past 50 years has been preceded by a large positive financing gap where the corporate sector overexpanded and was forced to cut back aggressively during the downturn. This time, the financing gap is deeply negative, indicating that the corporate sector is accumulating reserves, even after paying for capex.

U.S corporate financing gap



Financing gap = capital expenditures minus internal funds. Source U.S. Federal Reserve. Gray bars show recessions

The financing gap won't necessarily prevent a recession if the Fed moves aggressively. It does, however, argue against a deep and prolonged recession.

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Regional snapshots

United Kingdom

The UK economy is beginning to soften, and GDP is likely to have declined in the second quarter. Inflation remains high, with the core consumer price index (CPI) near 6% in the year to May. The unemployment rate, at 3.8% in April, is the lowest in nearly 50 years. Since December, the Bank of England has lifted interest rates five times to take the base rate to 1.25%. Futures markets predict that the rate will peak at 3.5% by the middle of next year.

The economy is likely to continue slowing as households cope with rising mortgage rates, high energy prices and the 1.25% increase in the national insurance levy that took effect in April. The Bank of England has recently softened its hawkish rhetoric and faces a difficult balancing act between reining in inflation expectations and preventing a sharp economic downturn.

The FTSE 100 continues to represent the best-performing major equity market this year. Most of the companies within the index generate their revenues outside of the UK. With high exposure to commodity prices and financial stocks that benefit from higher interest rates and almost no exposure to under-pressure technology stocks, the UK is the cheapest of the major equity markets and the FTSE 100 offers a dividend yield of 3.9% as of June 2022.

United States

A large and protracted inflation overshoot has created serious challenges for the U.S. outlook. Monetary policy now looks poised to pivot into restrictive territory by September. The Fed's policy shift is warranted by the broadening of the inflation experience into stickier categories, but the shift carries with it significant risks for the economy and markets.

Two of the signposts we look for to determine if we have entered the late cycle – an exhaustion of spare capacity and a restrictive monetary policy stance – now look to be in place by year-end. The Fed thinks it can engineer a soft landing, but economic history suggests it will not be easy to achieve. We judge that recession risks at around 30% through mid-2023 are already higher than normal, and they are likely to increase further as the Fed's expected shift to taking the punch bowl away[2] is realised in the months ahead.

The good news is that the large year-to-date selloff in U.S. equities has embedded many of these risks into the price. U.S. equity valuation multiples aren't as rich anymore. And our contrarian sentiment indicator sketches a market psychology that has grown very pessimistic – a positive tactical signal within our investment decision-making process. With cycle concerns and sentiment pulling hard in different directions, we prefer a balanced approach to U.S. equity exposure in portfolios. By contrast, U.S. Treasuries look increasingly attractive – both in terms of expected return and diversification potential, with the 10-year U.S. Treasury yield of 3.5% trading well above our estimate of fair value and above the central bank's target for inflation.

[2] In monetary policy jargon, "taking away the punch bowl" refers to a central bank action to reduce the stimulus that it has been giving the economy.

Eurozone

The clouds around the eurozone outlook continue to darken. The Russia/Ukraine war shows no sign of resolution, inflation pressures are increasing, the European Central Bank (ECB) has turned hawkish and peripheral risk is back in focus as Italian bond spreads widen.

The most significant risk is that Russia responds to the European Union's embargo of Russian oil exports by cutting off gas supplies to Europe. Europe's heavy dependence on Russian gas means that retaliation and a large rise in gas prices would almost certainly send the region into recession.

The ECB has recently turned hawkish, signaling a 25-basis-point (bp) rate rise is likely at its July meeting and that it is winding down its quantitative easing programmes. Futures markets expect the ECB's policy rate to rise from -0.5% currently to 2.0% by the middle of 2023. Headline inflation in the Eurozone reached 8.1% in May 2022, in line with the U.S. and the UK. However, core inflation (which excludes food and energy prices) is more subdued at 3.8% compared to around 6% in the U.S. and UK. This should allow the ECB to tighten policy by less than the Fed or Bank of England (BoE).

The ECB's other issue is the return of Italian debt risk with the spread between Italian and German government bonds widening sharply over the past two months. This threat prompted an emergency ECB board meeting to emphasise that the central bank would increase purchases of Italian bonds, if required, to counter fragmentation in the transmission of ECB policy across the Eurozone. The ECB meeting sent Italian spreads lower by 40 bps, but the episode serves as a reminder of the fragility within the Eurozone when growth slows and solvency comes under question.

Provided energy prices remain subdued and a recession is avoided, European economies have the potential to maintain trend-like economic growth. This outlook should allow the MSCI EMU Index, which reflects the European Economic and Monetary Union, to recover. Europe's exposure to financials and cyclically sensitive sectors such as industrials, materials and energy, and relatively small exposure to technology, should be an advantage as economic activity picks up and geopolitical risks subside.

Japan

The Japanese economy continues to face the challenge of higher energy and food prices, which have been exacerbated by the significant depreciation in the Japanese yen. This decline in the yen should improve the export-oriented parts of the economy through the second half of the year, although the positive impact on exports has been waning over time due to structural shifts in the Japanese economy.

Prime Minister Fumio Kishida recently announced his Grand Design economic plan, which will focus on raising wages and financing innovation in the economy. We will closely watch these announcements after the upper house election in July.

The Bank of Japan continues to stand out from other central banks (except for the People's Bank of China) in maintaining very accommodative policy. We think the Bank of Japan will be slow to raise interest rates, given core inflation is still only around 1%. With this dynamic, and the potential for stubbornly high energy prices for longer, the yen is likely to struggle despite attractive valuation.

China

The recent lockdowns in China have seen economic activity slow significantly through the second quarter, but we are now seeing early signs of tentative reopening. The low level of vaccination among the elderly in China means the risk of further lockdowns will continue until either vaccination rates increase or COVID-19 treatment production reaches critical mass.

Our expectations for more monetary and fiscal easing have started to be met, with the People's Bank of China cutting interest rates and the government announcing more infrastructure spending. We expect more fiscal stimulus, most likely in the form of consumption vouchers. Further easing measures should help the under-stress property market stabilise in the second half of the year.

Finally, and importantly for emerging market equities, is the outlook for Chinese regulation on technology companies. The government has announced intentions to reduce the uncertainty around regulation, which would be a net positive.

Canada

The Canadian economy benefits from high commodity prices, with GDP growth expected between 3.5% and 4.0% in 2022. This has encouraged the Bank of Canada (BoC) to respond with aggressive rate hikes to bring down generationally high inflation. The BoC has raised its policy rate to 1.5% from 0.25%, and Governor Tiff Macklem has indicated that future rate hikes may need to be "quicker" and "larger," with the target rate potentially settling "somewhat above" the 2% to 3% neutral range.

The BoC's unmistakably hawkish tone has been surprising, especially since signs are emerging that housing market fundamentals are unwinding. Notably, industry surveys indicate that rising rates are straining household finances and confidence. We believe the developing instability of Canadian housing will eventually limit the BoC. However, more conclusive signs of a housing correction may need to emerge before the BoC can pivot. This raises the risk that rates will rise above neutral before a policy shift occurs. We maintain our preference for Canadian equities relative to the U.S., as they benefit from more attractive relative value and high commodity prices.

Australia & New Zealand

The Australian economy has been one of the beneficiaries of the Ukraine conflict, given its position as a gas and wheat exporter. Economic tailwinds from the reopening are ongoing and consumer spending is still quite strong. Interest rate increases and higher fuel costs, however, have caused consumer confidence to fall.

The Reserve Bank of Australia (RBA) has raised rates from 0.1% to 0.85%, and the market expects the cash rate to reach 4% by early next year. We think this is too aggressive, given the heavy use of variable-rate mortgages and the impact this will have on household disposable incomes.

The Australian equity market is trading at a discount to global equities, and Australian government bonds also look attractive relative to global peers on a valuation basis. We think there is upside to the Australian dollar from here, given the boost from commodity prices.

Finally, we don't think that the recent election and change of government alters the outlook. Both major parties campaigned on similar policies. We look to the November mid-year fiscal update for more clarity on any new policy initiatives.

We are more cautious on the New Zealand outlook relative to Australia. New Zealand has a larger negative impact from rising oil prices as a net energy importer, and the Reserve Bank of New Zealand (RBNZ) has been more aggressive in raising interest rates than the RBA. Inflation is notably higher in New Zealand than Australia. We see increasing signs that the New Zealand housing market is under pressure, with new mortgage growth slowing and the supply of properties for sale increasing significantly over the last 12 months. Further house price declines and weaker consumer spending seem likely given the hawkish signals from the RBNZ.

> *Europe's heavy dependence on Russian gas means that retaliation and a large rise in gas prices would almost certainly send the region into recession.*
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> **Andrew Pease**

Asset-class preferences

There has been nowhere to hide for investors this year, with global equities in a bear market and bond yields rising. Our cycle, value and sentiment (CVS) decision-making process, however, cautions against becoming too pessimistic. Sentiment is extremely oversold and at levels last reached during the COVID-19 market panic of March 2020. Our valuation methodology scores U.S. Treasuries as cheap.

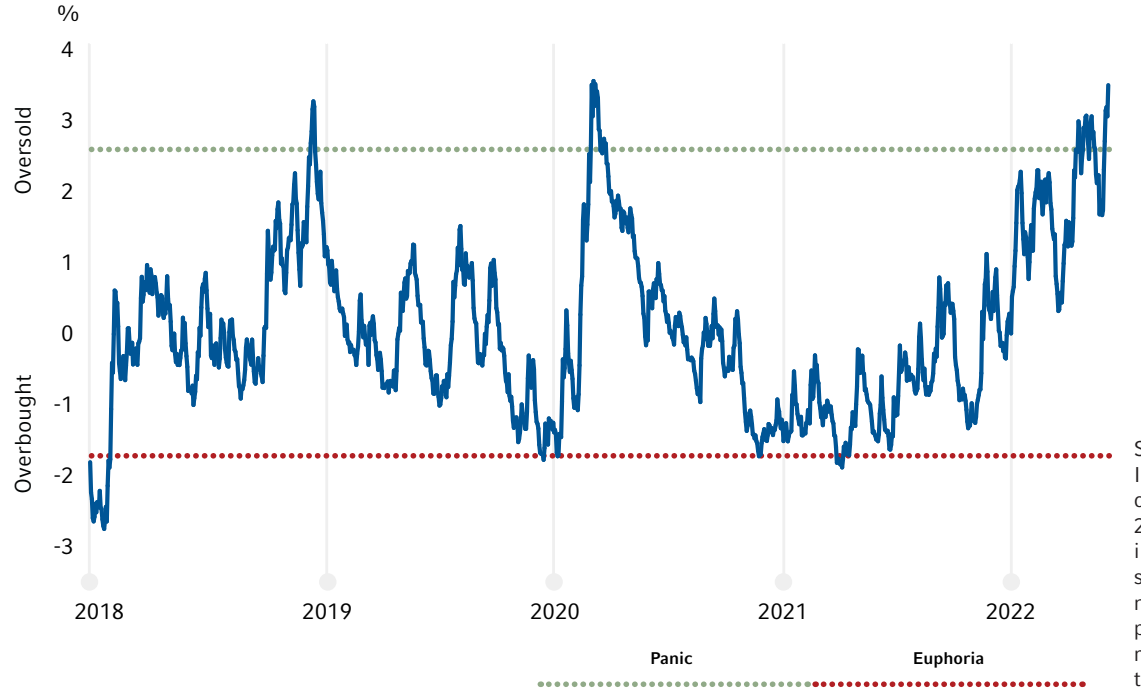
Equity valuation is harder to benchmark, given uncertainties around mean reversion for price-to-earnings (PE) multiples and profit margins. Technology companies have maintained higher margins than traditional firms and now constitute a large proportion of the U.S. index. The 1-year forward PE multiple for the S&P 500 as of mid-June is now around 16 times, down from 21 times at the beginning of the year. The median multiple since 1990 is 15.4 times. This makes it difficult to gauge if U.S. equities are outright cheap, although value has clearly improved.

The challenge comes from uncertainty around the cycle outlook. Aggressive central bank tightening and the threat of higher energy prices from the Russia/Ukraine war make a U.S. recession in 2023 possible.

The bullish argument is that U.S. core inflation has peaked. This, combined with some softening in the labour market and stability in energy prices, could allow the Fed to become less hawkish in the second half of 2022. Lower inflation will boost real incomes and could trigger a renewed upswing in equity markets. Deeply oversold sentiment combined with peak market expectations for Fed hawkishness could be the catalyst for an equity market rebound. This is an appealing scenario but may take some time to occur with central banks still aggressively raising interest rates.

The U.S. dollar (USD) has made strong gains this year. It has benefited from Fed hawkishness and its safe-haven appeal during times of market volatility. The euro, yen and British sterling are now significantly under-valued on a longer-term basis. The argument for USD weakness in the second half of the year is similar to the rationale for becoming bullish on equities and bonds: inflation pressures subside, and the Fed becomes less hawkish. Dollar weakness should support the performance of non-U.S. markets, particularly emerging markets.

Composite contrarian indicator: Sentiment for equity markets rises above panic level



Sources: Russell Investments. Last observation: 16 June 2022. Contrarian indicators for investor sentiment give a numeric measure of how pessimistic or optimistic market actors are through time.

We prefer **non-U.S. developed equities to U.S. equities**. They are relatively cheaper and will benefit from U.S. dollar weakness should the Fed become less hawkish.

Emerging market equities could recover if there is significant China stimulus, the Fed slows the pace of tightening, energy prices subside and the U.S. dollar weakens. For now, a neutral stance is warranted.

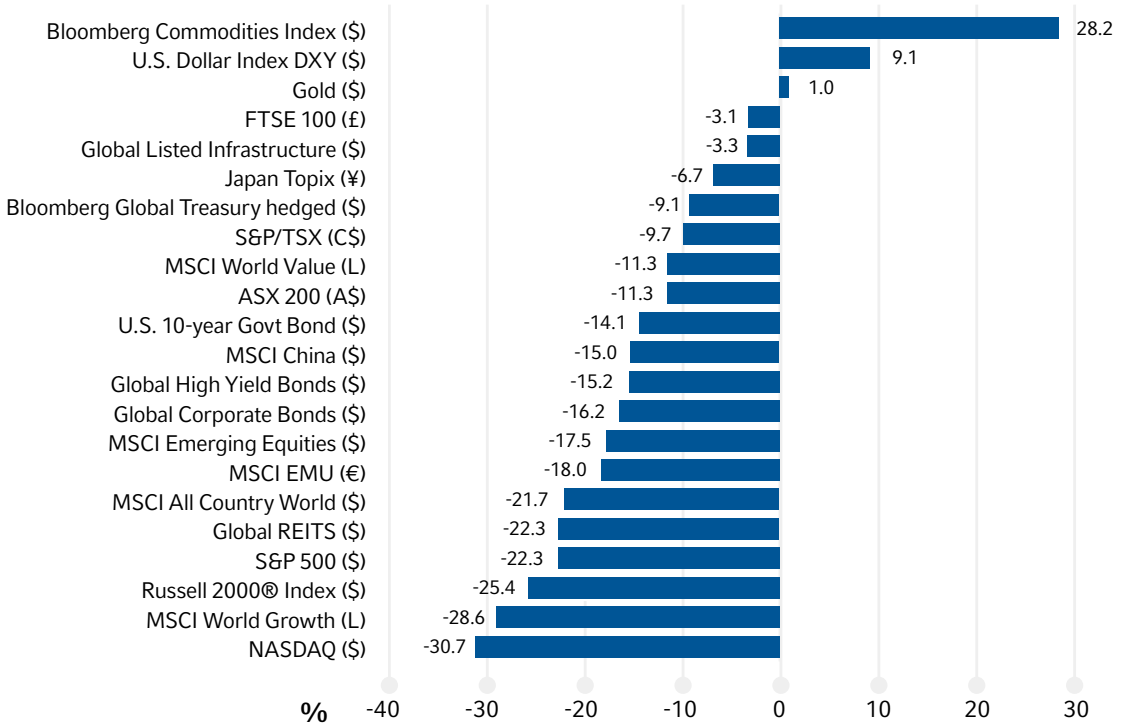
High yield and investment grade credit are starting to show better value with spreads above their long-term averages. Spreads will remain under upward pressure if U.S. recession probabilities increase, and the Russia/Ukraine conflict escalates. High yield and investment grade should perform well if the Fed becomes less hawkish and an economic soft landing becomes likely. We have a neutral outlook on credit markets for now but can see the case for becoming more positive if a U.S. recession becomes less likely.

Government bond valuations have improved after the rise in yields. U.S. bonds now offer good value, although Japanese, German and UK bonds are still moderately expensive. A positive for government bonds is that markets have fully priced hawkish outlooks for most central banks, and this should limit the extent of any further selloff.

Real assets: Global Listed Infrastructure (GLI) has been one of the better-performing asset classes so far this year, benefiting from energy exposure, while Real Estate Investment Trusts (REITs) have lost more than 20%. Both should benefit if Russia/Ukraine hostilities subside and inflation concerns continue, although GLI should give back some of the gains from energy infrastructure.
Commodities have been the best-performing asset class and the only one to post a positive return. Energy and agricultural prices have surged on the Russia/Ukraine conflict. Some of these gains will be reversed if hostilities subside. One risk for commodity markets is that China's economy continues to slow. On balance, the case for commodities exposure is still positive, but weaker growth as central banks tighten policy will dampen demand.

The **U.S. dollar** has made gains this year on Fed hawkishness and safe-haven appeal during the Russia/Ukraine conflict. It should weaken if hostilities subside and if lower inflation outcomes later in the year lead to less Fed tightening than markets currently expect. The main beneficiaries are likely to be the **euro**, which has become more undervalued, and the **Japanese yen**, which has weakened on commodity price inflation and China growth concerns. We also believe **British sterling** and the economically sensitive commodity currencies – the **Australian dollar**, **New Zealand dollar** and **Canadian dollar** – can make further gains.

Year-to-date returns as at 17 June 2022



Source: Refinitiv® DataStream®, as of 17 June 2022. (L) implies local currency.

> *Our cycle, value, and sentiment decision-making process cautions against becoming too pessimistic.*
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> **Andrew Pease**

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