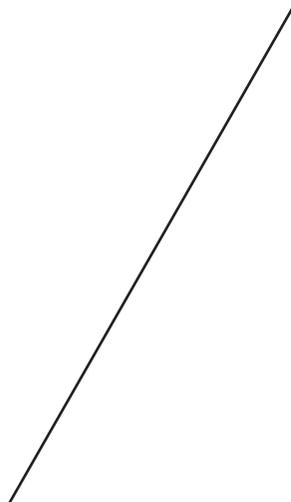


Q4

2022

POWELL
PIVOT
POSTPONED



GLOBAL
MARKET
OUTLOOK

SYNOPSIS

Central banks haven't finished tightening and the US Treasury yield curve remains inverted. We believe that slowing core inflation should allow the US Federal Reserve (Fed) to go on hold in early 2023, and that oversold equity-market sentiment means a lot of bad news is already priced in.

KEY MARKET THEMES

Markets had stabilised somewhat over the past three months, but it remains an *annus horribilis* for investors, with equities and government bonds posting negative returns so far this year. Investors remain worried about high inflation, slowing growth and the potential for an aggressive Fed to cause a recession.

It's hard to find much good news at present, but one source of comfort is that investor sentiment is very negative. Our composite sentiment index, which measures investor sentiment for the S&P 500® Index via a range of technical, positioning and survey indicators, is near two standard-deviations oversold. We believe this provides some reassurance that markets have accounted for the bad news so far.

While it's too early to predict that a recession is the most likely outcome for the US economy during 2023, we believe the probability is rising. The main warning comes from the inverted Treasury yield curve, where the spread between the 10-year yield and the 2-year yield is the most negative in 40 years. Some of the leading indicators for the US economy, such as the Institute for Supply Management's index for new orders, have softened. The indicators that the Fed is focused on, such as payrolls and wages, remain overheated. These labour-market trends tend to lag the broader economy. This creates the risk that the Fed will continue to tighten while the economy weakens. We're still in the soft/softish landing camp for the US, and expect that strong household and corporate finances can limit the downturn to, at worst, a mild recession.

In Europe, a challenging winter lies ahead. High energy costs will depress consumer spending and industrial production, while persistently high inflation will likely lead to continued tightening from the European Central Bank (ECB). The Russia-Ukraine war is no closer to being resolved, and with measures of industrial production beginning to decline in response to high energy prices, it's difficult to see the region avoiding at least a mild recession.



In the UK, the economic downturn is already underway. Gross domestic product (GDP) growth was negative in the second quarter, and it's likely that the economy contracted again in the third quarter. Inflation hit 9.9% in August, and the Bank of England's strict 2% inflation target means more rate hikes are on the way despite the slowing economy.

In China, the economy remains weak, but stimulus is happening, albeit gradually. We believe that the end of China's resurgent COVID-19 lockdowns – hopefully by early next year – should allow growth to recover.

In Japan, some investors are now challenging the Bank of Japan (BOJ)'s commitment to policy accommodation. However, we believe that the bank will maintain its yield-curve control for now. Importantly, most measures of underlying inflation are still running well below the BOJ's 2% target, the yen's boost to import prices is likely to be a transitory phenomenon and wage growth remains tepid.

In Australia, the high share of variable rate mortgages means there is a direct link from central-bank rate hikes to the housing market. Market pricing has the Reserve Bank of Australia's cash rate peaking near 4% in mid-2023.

In Canada, we believe financial conditions will continue to tighten from already restrictive levels, making a recession nearly unavoidable. Canadian equities haven't been immune to the global drawdown in equities, but have held up well relative to global shares and may continue to do so.

ECONOMIC VIEWS



FED POLICY STANCE

We believe it is unlikely that Fed Chair Jerome Powell will navigate a pivot to a less-hawkish stance before early in 2023.



CHINA GROWTH

We expect China to grow at a meager 2%-3% pace in 2022, with the potential for these risks to bleed into 2023, as a slowing developed-market consumer may also begin to weigh on the tradeable goods sector.



EUROPEAN RECESSION RISKS

We think that the combination of high inflation and surging gas prices will likely plunge Europe into a recession during the northern winter.



ECB POLICY RATE

We estimate that the ECB's policy rate will peak near 2.5%, which would be one percentage point above our estimate for the neutral policy rate in Europe.



US INFLATION FORECAST

We anticipate that core inflation in the US will fall from over 6% currently to 3.5%-4% over the next several months.

ASSET CLASS VIEWS

Equities: Small preference for non-US developed equities

We have a small preference for non-US developed equities to US equities. They are relatively cheaper and will benefit from US-dollar weakness should the Fed become less hawkish.

Fixed income: Improved valuations for government bonds

We think government bond valuations have improved after the rise in yields. We see US, UK and German bonds as offering good value, while Japanese bonds still look expensive, with the Bank of Japan aggressively defending the 25-basis-point yield limit. We see the risk of a further significant selloff as limited, given that inflation is close to peaking and markets have priced in hawkish outlooks for most central banks.

Currencies: Strong US dollar could weaken if inflation declines

The US dollar has made gains this year on Fed hawkishness and safe-haven appeal during the Russia-Ukraine conflict. It could weaken if inflation begins to decline and the Fed pivots to a less hawkish stance in early 2023. The main beneficiaries of this are likely to be the euro and the Japanese yen.



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