

# Q4

2022

POWELL  
PIVOT  
POSTPONED

GLOBAL  
MARKET  
OUTLOOK



## Powell pivot postponed

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



*It's too early to predict that a recession is the most likely outcome for the US economy during 2023, but the probability is rising.*

**Andrew Pease, Global Head of Investment Strategy**



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# Introduction

Markets stabilised somewhat over the past three months, but 2022 remains an *annus horribilis*<sup>1</sup> for investors with both 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](#), but one source of comfort is that investor sentiment is very negative, providing some reassurance that markets have already accounted for the bad news. 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.

## Are the chances for a US recession increasing?

It's too early to predict that a recession is the most likely outcome for the US economy during 2023, but the probability is rising. The main warning comes from the inverted yield curve, where the spread between the yields on the 10-year and 2-year Treasury bonds 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 labor-market trends tend to lag the broader economy. This creates the risk that the Fed will continue to tighten even as the economy weakens. It also means Fed Chair Jerome Powell is unlikely to navigate a pivot to a less hawkish stance before early in 2023.

Recession, however, seems unavoidable for the eurozone and UK, where surging prices for natural gas are hitting hard. China's economy remains weak, but stimulus is happening, albeit gradually. The end of China's resurgent COVID-19 lockdowns, hopefully by early next year, should allow growth to recover.

## What type of recession could the US see?

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.

The arguments against a deep US recession are that household and business balance sheets are in good shape, and [moderating inflation](#) could drive a recovery in real spending power. This outcome, however, relies on the Fed slowing the pace of tightening and pausing at only a moderately restrictive level.

We expect inflation to trend lower over coming months, which along with signs of softer growth, should allow the Fed to pause once the target rate is around 4.0-4.5%. Fed tightening phases, however, are usually anxious times for markets. Investors are likely to worry about excessive monetary tightening and the risk of a more severe recession. It's possible that the mid-June lows for equity markets will be re-tested, and markets are likely to remain volatile until inflation is clearly trending lower.

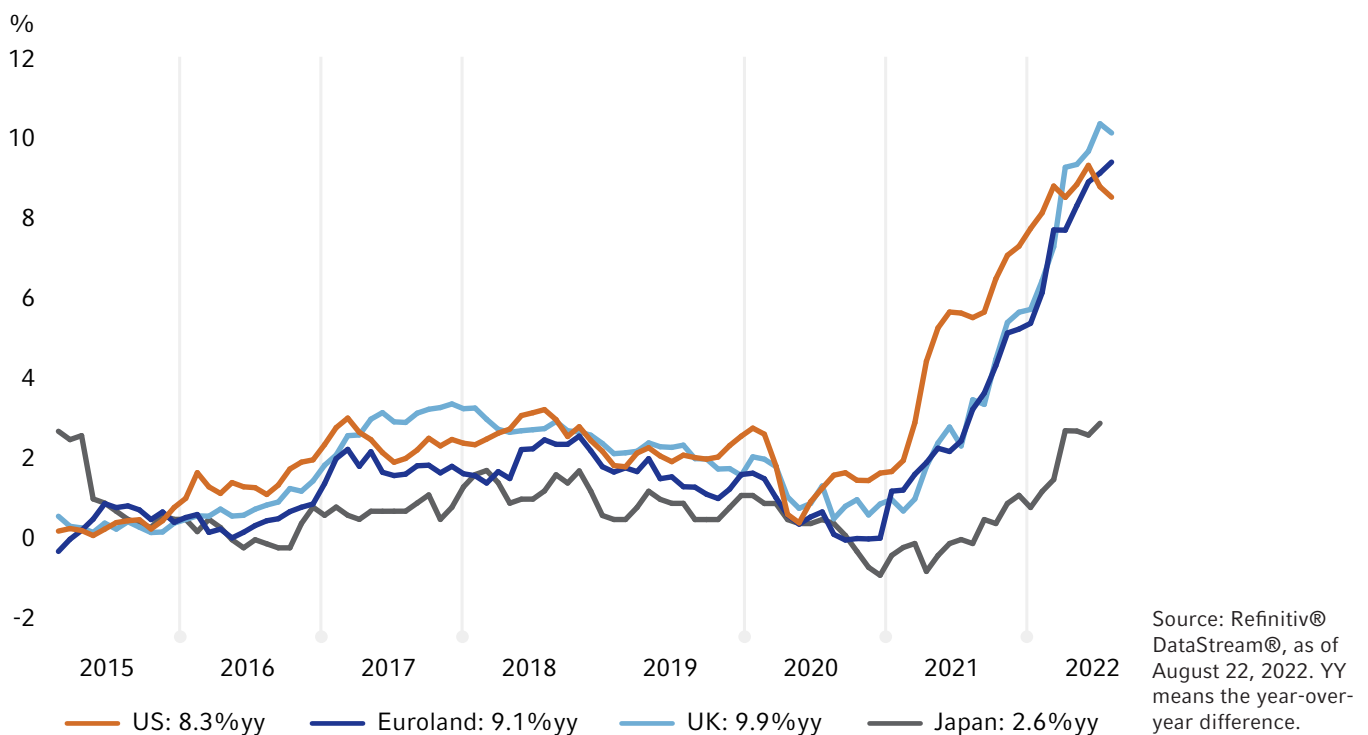
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<sup>1</sup> This Latin phrase, meaning 'horrible year', was brought to modern prominence by Queen Elizabeth II in a 1992 speech marking her Ruby Jubilee on the British throne.

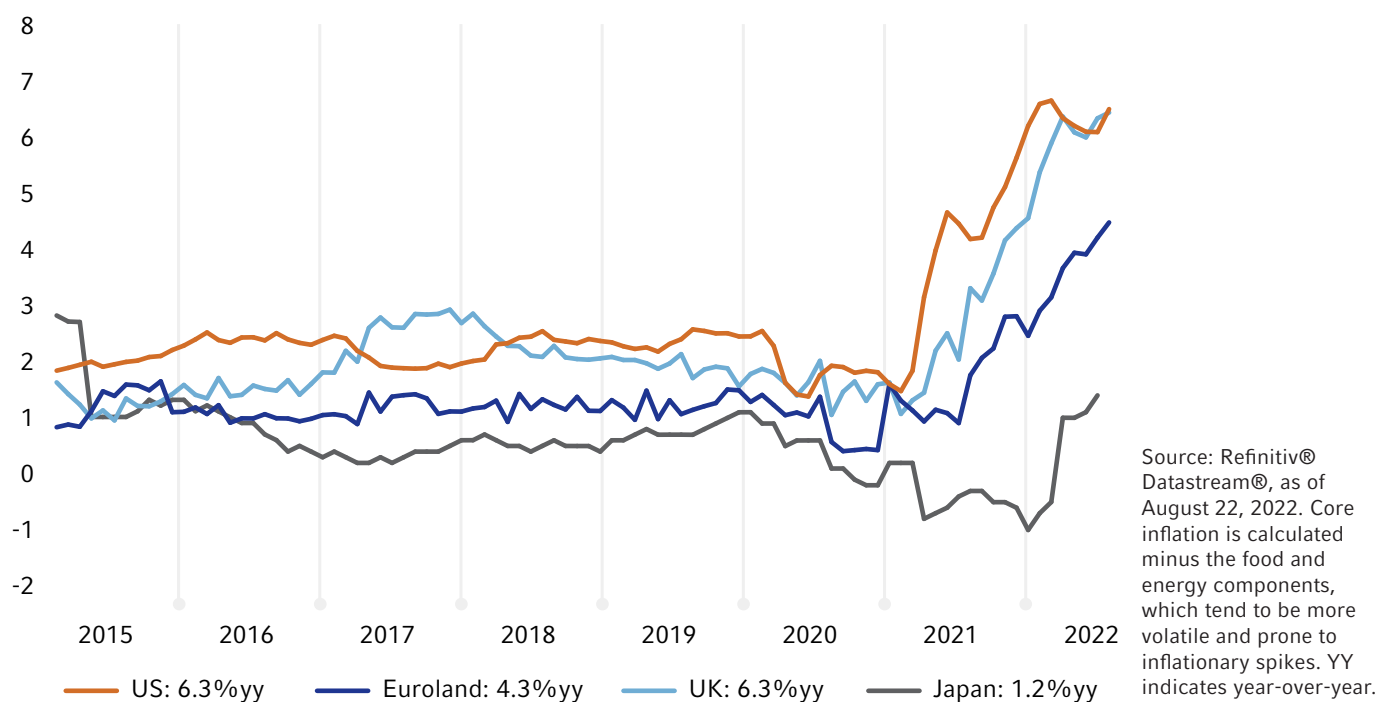
# Inflation likely to moderate

Inflation has remained stubbornly high during 2022. This has been partly due to high energy costs caused by the Russia-Ukraine war. It has also been the result of cost pressures generated by pent-up demand as economies re-opened from lockdowns and firms scrambled to hire staff to meet this demand.

## Global inflation rates



## Global core inflation rates



Inflation should be on a downward trend across developed economies over the next few months. For headline inflation, this requires that oil and natural gas prices at least stabilise at current levels. Oil prices have already fallen around 30% from their post-invasion peak in March. Natural gas prices have also fallen and should remain contained now that Europe has managed to fill gas storage to almost 90% of capacity ahead of the northern winter.

### Has core inflation peaked?

Core inflation, which excludes food and energy costs, is [close to peaking in most regions](#). Measures of supply chain bottlenecks have eased, and industrial commodity prices have trended lower over the past few months. 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. These disinflationary forces should allow core inflation in the United States to fall from over 6% currently to 3.5%-4% over the next several months.

The issue for central banks, however, is whether inflation can return close to 2%. This will require a slowdown in employment creation and for wage growth to cool from the almost 7% current annual rate of increase in the United States. The monetary tightening so far should ease labour demand over the coming months, but central banks will want evidence that the jobs market is slowing before backing off from rate hikes.

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**Andrew Pease**

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# Europe's energy shock

Natural gas accounts for about a quarter of Europe's energy supply. Before the war, around 40% of that gas came from Russia. The natural gas price was averaging around €16/megawatt hour (mwh) in the five years to 2020 before surging to around €200/mwh currently. This is the equivalent of oil prices rising to \$600 per barrel. This magnitude of [energy-price shock makes a recession almost inevitable](#).

European governments have tried to offset the shock by filling gas storage, securing new sources of supply (Europe is now the United States' biggest market for liquid natural gas), postponing the shutdown of nuclear power plants and restarting coal-fired power plants.

## How are European governments responding to the energy crisis?

Nearly €400 billion in government support measures have been announced and more packages seem likely before households are hit by surging winter heating costs. The additional headwind, however, is that monetary policy is heading in the other direction. [The European Central Bank \(ECB\) has lifted rates](#) twice since July to 1.25%. Financial markets expect the policy rate to peak at 2.5% in early 2023. This is around one percentage point above our estimate for the neutral policy rate in Europe.

## What type of recession is the UK facing? What about continental Europe?

The outlook is more precarious for the United Kingdom, where natural gas accounts for 40% of energy use. [Inflation pressures are stronger in the UK](#) due to labour supply shortages. The Bank of England (BOE) has already lifted the policy rate to 2.25% and markets expect the rate to peak at 4.5% in mid-2023. The new prime minister, Liz Truss, is planning a support package of energy price caps and tax cuts that could amount to nearly 8% of gross domestic product (GDP). This should prevent a deep recession and soften the inflation impact.

The policy support in the UK and the energy transition from Russian gas in Europe suggest the winter recession should be relatively shallow. For Europe, this creates the potential for a spring rebound as inflation declines and the ECB pivots to a less hawkish stance. The post-winter outlook is less clear-cut for the UK. The massive Truss stimulus combined with post-Brexit labour supply shortages will have the BOE concerned about inflation becoming entrenched. The UK's recession may not be deep, but the recovery could be disappointingly slow.



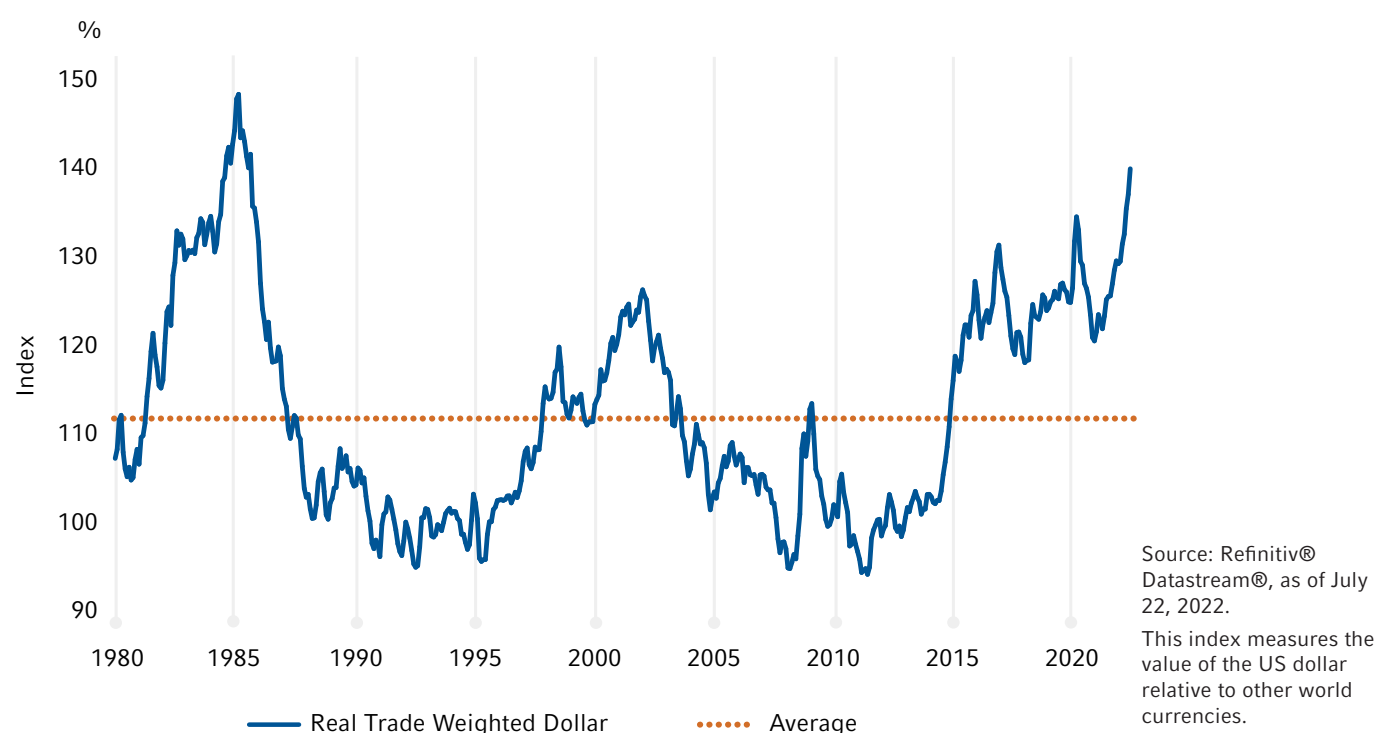
*The US dollar has been on an upward trend for over a decade but 2023 might be the year that it starts to reverse.*

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# Currencies move to extremes

The post COVID-19 recovery, inflation surge and energy price shock have triggered large currency extremes. The US dollar has benefited from Fed hawkishness and its safe-haven appeal during times of market volatility. In real trade-weighted terms, the US dollar is the strongest since the Plaza Accord<sup>2</sup> era of the mid-1980s.

## US real trade-weighted dollar reaches highest level in decades



<sup>1</sup> The **Plaza Accord** was an agreement signed on September 22, 1985 at the Plaza Hotel in New York between France, West Germany, Japan, the UK, and US to depreciate the U.S dollar in relation to the other countries' currencies by intervening in currency markets.

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The euro, Japanese yen and British sterling are now significantly under-valued on a longer-term basis. The euro is 30% below its purchasing power parity value and sterling is 20% undervalued on this measure. The outlier is the yen which is 35% undervalued.

### Could the US dollar weaken next year?

The US dollar (USD) has been on an upward trend for over a decade but 2023 might be the year that it starts to reverse. This scenario requires that inflation pressures subside, and the Fed becomes less hawkish. This same scenario should allow the euro to rebound, particularly if natural gas prices fall further. The European economy has a strong link to Chinese growth. A rebound in Chinese activity as *zero-tolerance* lockdowns end and more stimulus is implemented will also support the euro.

Japan's inflation trends have lagged the rest of the world, and the Bank of Japan (BOJ)'s strong defense of its 25-basis-point limit for 10-year Japanese government bond yields has pushed the yen lower. BOJ Governor Haruhiko Kuroda's term expires next April, and his successor may favour a shift away from aggressive yield-curve control.

The risk to this view of a peak in the US dollar is that inflation pressures continue to build, and the Fed becomes more hawkish. Dollar weakness, however, will support the performance of non-US equity markets, particularly emerging markets.



*Measures of eurozone industrial production are beginning to decline in response to energy prices and it's difficult to see the region avoiding at least a mild recession.*

**Andrew Pease**



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# Regional snapshots

## United Kingdom

The [UK economic downturn is already underway](#). GDP growth was negative in Q2 and it's likely that the economy contracted again in Q3. 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.

The upcoming fiscal support package from the new prime minister, Liz Truss, could be as large as 8% of GDP. It will be a combination of energy price caps and a reversal of the tax hikes implemented by the former chancellor, Rishi Sunak.

The unemployment rate at 3.6% is the lowest since 1973 and this is providing support to household incomes ahead of the wintertime energy price surge. The Truss stimulus, however, creates the risk of further BOE tightening. The UK's recession may not be deep, but the recovery could be disappointingly sluggish.



## United States

Inflation remains the dominant macroeconomic issue for US markets. Inflation dynamics were mixed over the quarter. Encouragingly, retail gasoline prices fell by more than 20% from mid-June, supply chains are tentatively healing, and some of the most volatile drivers of US inflation, such as durable goods prices, are moderating.

The labor market, however, is still red-hot with two available job openings for every unemployed worker. High-quality measures of wage inflation were running at a blistering 7% clip through August. Wages are a *sticky* driver of inflation and put pressure on the Fed to move decisively into a restrictive monetary policy setting. Lowering inflation requires the Fed to engineer an economic slowdown through higher rates and/or lower

asset prices. It's an unfavourable macro backdrop for investors. The good news is that these concerns are, at least partially, already reflected in the markets. The S&P 500 is down 17% on the year to Sept. 14. Industry consensus earnings estimates for 2022 and 2023 are in a downgrade cycle—even if we think they have further to fall. US 10-year Treasury yields have risen almost 200 basis points this year and at 3.4% offer a decent yield (in excess of expected inflation and our estimate of fair value). We are not bullish on the economic outlook, particularly given the heightened uncertainty around the path forward, but with a degree of pessimism already in the price, we believe that maintaining overall positioning near strategic targets is warranted.



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## Eurozone

The region has a challenging winter ahead. High energy costs are expected to depress consumer spending and industrial production. [Persistently high inflation](#) should see the European Central Bank (ECB) continue to tighten monetary policy. The Russia-Ukraine war is no closer to being resolved and Italian political uncertainty continues to place upward pressure on Italian bond yields.

Nearly €400 billion in government support measures have been announced in response to the energy crisis, and more packages seem likely. The European Union (EU) has announced a plan for 10% in energy saving and an EU-wide price cap that will be at least partly funded by a windfall tax on energy producers.

Measures of industrial production are beginning to decline in response to energy prices, and it's difficult to see the region avoiding at least a mild recession. The severity of this year's winter will be important since a colder than usual season will generate a deeper recession.

European growth, however, should rebound in the spring. Inflation should be on a downward trend, and this should limit the amount of ECB tightening.



## Japan

Japan is unique among the major advanced economies with its benign inflation backdrop and accommodative monetary policy stance. The yen has been a casualty of that policy divergence, depreciating nearly 20% against the US dollar in the year to mid-September.

Some investors are now challenging the Bank of Japan's commitment to policy accommodation. However, we believe the Bank of Japan will maintain its yield-curve

control for now. Importantly, most measures of underlying inflation are still running well below the Bank of Japan's 2% target, the yen's boost to import prices is likely to be a transitory phenomenon, and wage growth remains tepid. It would take a significant change in domestic demand for a policy pivot to occur before Governor Kuroda's term expires in April 2023.



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## China

The Chinese economy has weakened significantly in 2022 on the back of rolling COVID-19 lockdowns and the property sector slump. While policymakers have started to stimulate the economy with rate cuts and infrastructure spending, these measures have thus far proven inadequate to reinvigorate 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. The Politburo meeting in late October will be an important

watch point for investors. Expectations are that President Xi Jinping will consolidate power for a third five-year term. From a macroeconomic perspective, any plans to relax COVID-19 restrictions or to relax the focus on *high quality* growth in favour of shorter-term performance will be closely scrutinised. Given elevated economic and policy uncertainty in China, our exposures have primarily been targeting the market as an alpha opportunity, with our underlying active managers looking to add value by differentiating winners and losers at the security level.



## Canada

Home resales are down 24% since the start of the year, and home prices are starting to tumble, particularly in the major cities. Rapidly rising interest rates are finally shaking the seemingly unshakeable housing market. Even so, the Bank of Canada remains focused on uncomfortably high inflation. The bank seems willing to sacrifice economic growth to combat inflation and stop inflation expectations from becoming unanchored.

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. However, downside risks remain due to the cyclical nature of Canadian shares, making them more vulnerable to a recessionary selloff.



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## Australia and New Zealand

Housing markets are the key source of concern in both economies. House prices rose rapidly during the pandemic and both countries have high levels of housing debt. In Australia, household debt as a share of disposable income is close to 200%.

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 (RBA) cash rate peaking near 4% in mid-2023. The Reserve Bank of New Zealand's (RBNZ) cash rate is priced to peak at 4.5%.

Already, there are signs that housing activity is slowing in both countries and house prices have begun to decline. Both economies are poised to slow over the next year, but we expect that recession will be avoided. The RBA has demonstrated in the past that it will pull back from aggressive action if the housing market weakens sharply.

We are more cautious on the New Zealand outlook since core and headline inflation are notably higher than in Australia. Market pricing appears too aggressive for the peak in the RBA rate, but the RBNZ seems likely to tighten in line with market expectations.



*Our cycle, value, and sentiment (CVS) investment decision-making process has a neutral view on the outlook for the fourth quarter of 2022.*

**Andrew Pease**

# Asset-class preferences

There was some relief for investors over the past three months with global equities posting moderately positive returns. Markets, however, were under pressure in late September as central banks continued to tighten policy and inflation remained high.

## Where is the business cycle headed?

Our cycle, value, and sentiment (CVS) investment decision-making process has a neutral view on the outlook for the fourth quarter of 2022. Equity sentiment is oversold but is not at the extremes recorded in June, prior to the market rebound. In June our sentiment index reached oversold levels last recorded during the Covid-19 market panic of March 2020.

The cycle outlook has deteriorated further and is a headwind for equity markets. We're not yet ready to predict that a recession is the most likely outcome for the US economy in 2023, but the probability is rising. Chairman Powell's [address at the Jackson Hole Symposium in late August](#) made it clear the Fed will continue to tighten monetary policy until inflation is trending lower. He was explicit that monetary policy will remain restrictive for some time.

## Are equity valuations improving?

The 1-year forward price-to-earnings (P/E) multiple for the S&P 500 has fallen from 21 times at the start of the year to 16.5 times in late September. Our valuation methodology is not scoring US equities as cheap, but value has improved.

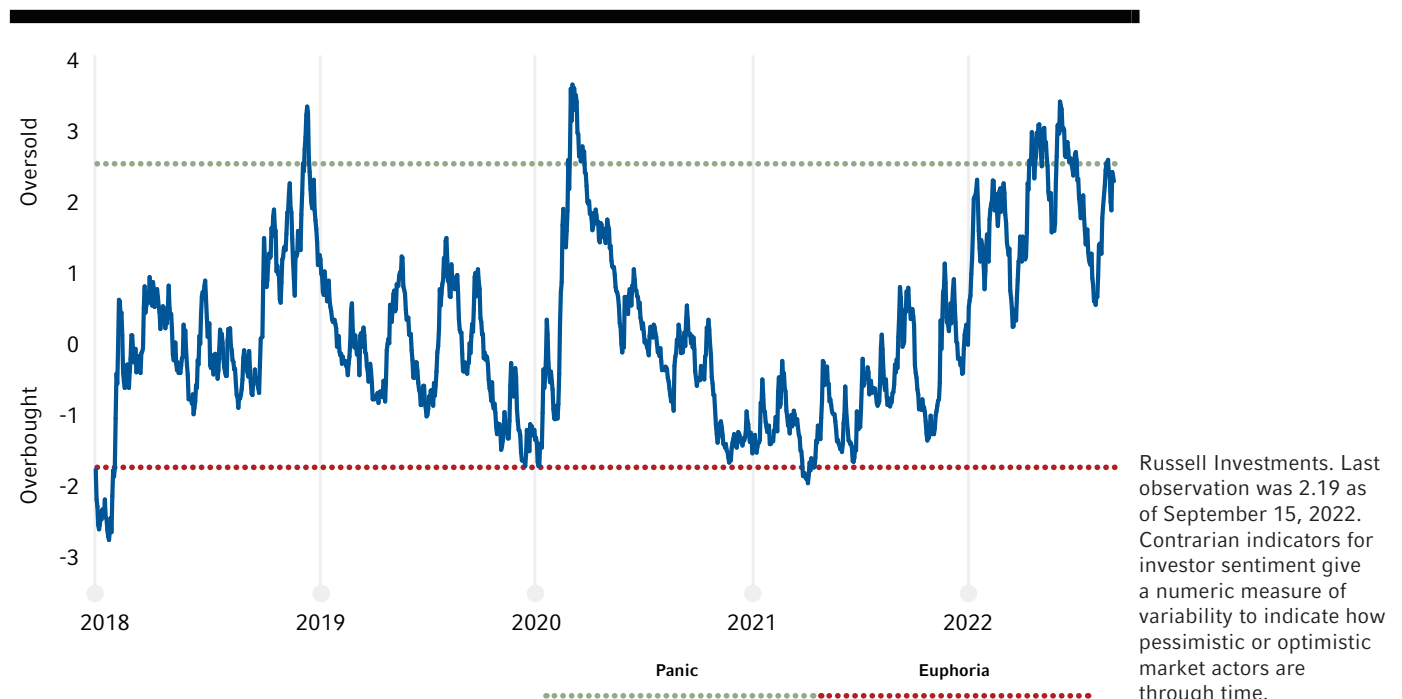
This methodology, however, suggests that non-US equities are now showing value.

## What's the outlook for government bonds?

The 10-year US Treasury at a yield of 3.5% is screening as good value on our valuation framework. Sentiment is also positive for Treasuries with positioning indicators showing that investors are crowded into short duration positions. The cycle, however, will not be supportive of a rally until there is a good case that market expectations for Fed tightening have peaked.

The US dollar 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 sterling are now significantly under-valued on a longer-term basis. The argument for USD weakness over the next 12 months is similar to the rationale for becoming bullish on equities and bonds: inflation pressures subside, and the Fed becomes less hawkish. Dollar weakness would support the performance of non-US markets, particularly emerging markets.

## Composite contrarian indicator



## Here is a summary of our asset-class views as Q4 2022 begins:



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.



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



**High yield** and **investment grade credit** spreads are near their long-term averages, although the overall yield on US high yield at about 8.5% is attractive. Spreads will remain under upward pressure if US recession probabilities increase. We have a neutral outlook on credit markets but will become more positive if a US recession becomes less likely.



**Government bond** valuations have improved. US, UK and German bonds offer good value. Japanese bonds are still expensive with the Bank of Japan aggressively defending the 25-basis point yield limit. Our methodology has fair value for Japanese government bond yields at around 50 basis points. Yields have risen sharply in most markets in recent months. The risk of a further significant selloff seems limited given inflation is close to peaking and markets have priced hawkish outlooks for most central banks.

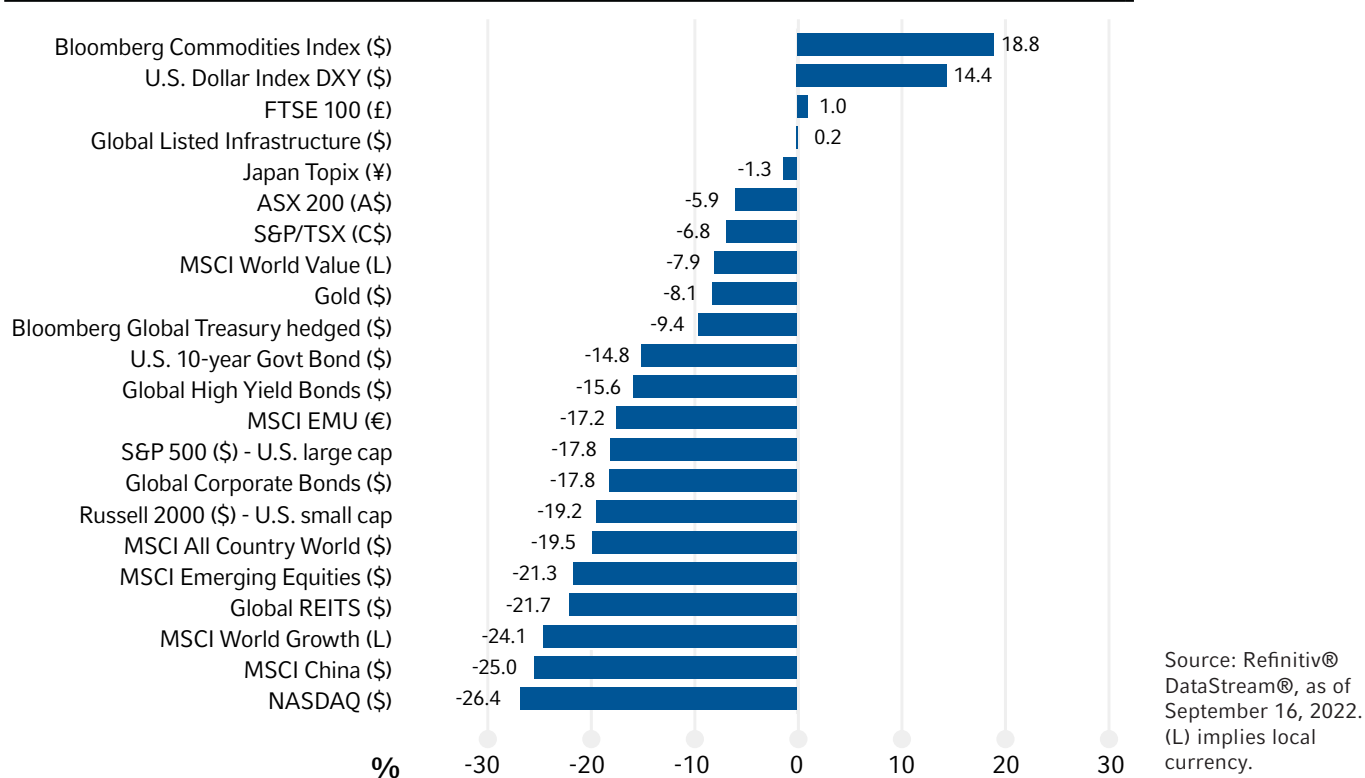


**Real assets:** Global Listed Infrastructure (GLI) has been one of the better-performing asset classes so far this year, while real estate investment trusts (REITS) have lost more than 20%. GLI is expensive on several measures, including dividend yields and price-to-earnings ratios. REITS, by contrast, show good value on these measures. REITS stand to benefit if a recession is avoided and post-pandemic normalisation continues. GLI has benefited from energy price gains this year and will be at risk if oil and gas prices decline. **Commodities** gave up some of their returns over the past three months but are still the best-performing asset class so far this year. Energy and agricultural prices have surged on the Russia-Ukraine conflict. Global recession is a risk for commodities, but one potential upside is a recovery in Chinese demand in 2023 as lockdowns ease and more stimulus measures are adopted.



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 are likely to be the euro and the **yen**.

## Year-to-date returns through September 16, 2022



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

**Andrew Pease**

## IMPORTANT INFORMATION

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