Q2 2022

GLOBAL MARKET OUTLOOK

DENTED, NOT DERAILED

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Dented, not derailed

Russia/Ukraine adds to near-term growth risks for the global economy and will keep inflation elevated for longer. Uncertainty is high, but equity markets are oversold and should recover if tensions ease in coming months.

> *The consequences of the invasion are lower global growth, with Europe taking the largest hit, and higher inflation.*
>
> **Andrew Pease, Global Head of Investment Strategy**

Introduction

Russia's invasion of Ukraine creates near-term risks for markets, but also casts a shadow over the longer-term outlook. The immediate threat comes from high energy prices, rising food prices and disrupted supply chains. The longer-term issues are a new cold war between Russia and the West, increased military spending and a further blow to globalization.

The war is a defining moment for Europe, which now needs to unwind decades of Russian energy dependence, accelerate its sustainable energy transition and rebuild military capability.

Markets had plenty to worry about before the invasion, including the onset of U.S. Federal Reserve (Fed) tightening, the impact of COVID-19 lockdowns on supply chains and inflation and the outlook for China with problems in the real estate sector, its zero-tolerance COVID-19 policy and heavy-handed regulation of technology firms.

Our theme for 2022 prior to the invasion was *The Great Moderation*. We expected global growth to moderate from the post-lockdown surge in 2021 but remain above trend. The consequences of the invasion are lower global growth, with Europe taking the largest hit, and higher inflation. Even so, global growth this year should still be above trend, provided hostilities ease and global energy prices stabilize. Above-trend growth should support equities over bonds and cash, but the conflict has created significant uncertainty, which means more market volatility.

Cycle outlook: still moderately above trend

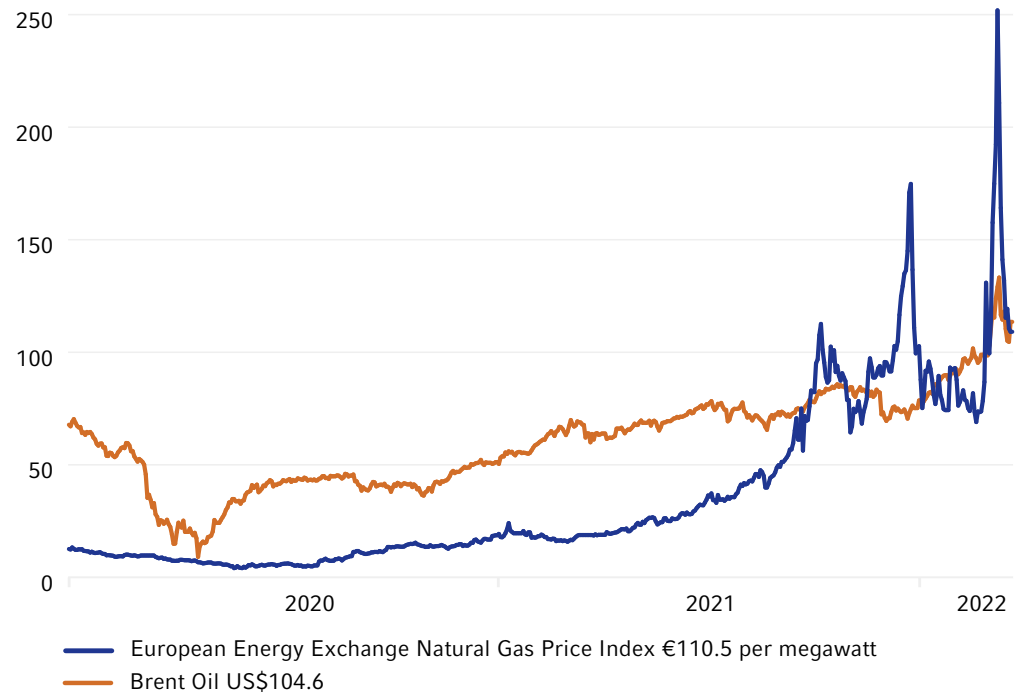
The main cycle risks from Russia/Ukraine come from:

- Energy prices and their impact on global growth and inflation
- Food prices, given Russia and Ukraine's importance in global wheat and corn exports
- Supply chain disruption, particularly for motor vehicle parts and semiconductor production

The energy price channel[1] is the most important, and oil prices sustained above $130 per barrel (bbl) could trigger a much larger global downturn and risk of a recession.

The minimal economic-damage scenario assumes that hostilities ease by mid-year, Russian energy supply is maintained, oil prices stabilize at around $100/bbl and European natural gas prices return to below €100 per megawatt hour (mwh). A lot of things must go right in this scenario, but the initial price spikes when the invasion occurred have been largely reversed.

Oil & natural gas prices: invasion price spikes largely reverse



Source: Refinitiv® Datastream®, as of March 17, 2022.

[1] A price channel forms when a security's price is buffeted by the forces of supply and demand. These forces affect the price of a security and the dominance of one force determines the price channel's trending direction.

The energy price channel matters more for Europe due to the dependence on Russian gas exports. Europe obtains more than 40% of its natural gas and 20% of its oil from Russia. Natural gas prices averaged around €20/mwh over the past decade. They spiked to €250 after the invasion. Natural gas supplies from Russia have not yet been disrupted, although this is still a risk, and the price has fallen back toward €100. Europe's ability to quickly switch to other sources of supply is limited. It's fortunate the energy crisis is unfolding in March, near the start of the northern spring, rather than October when heading into winter. A short-lived shock to energy prices should see European economies recover in the second half of the year. COVID-19 has become less deadly, post-pandemic reopening is underway and fiscal policy is supportive because of the European Recovery Fund. The Russia/Ukraine conflict means fiscal policy is likely to become slightly more supportive. Germany has committed to boost defense spending to more than 2% of gross domestic product (GDP), and both French President Emmanuel Macron and Italian Prime Minister Mario Draghi have called for less restrictive fiscal rules in Europe.

The global economy was on track for strongly above-trend growth in 2022. Before the invasion, the industry-consensus view was that the U.S. would grow by around 3.5% this year, Europe 4.0%, and the UK 4.5%. The war is unlikely to reduce U.S. growth by more than 0.5 percentage points, while the impact on European growth is likely to be 1.5-2.0 percentage points. We can put the UK mid-way between the U.S. and Europe. This takes 2022 GDP growth projections to 3.0% for the U.S., 2.5% for Europe and 3.5% for the UK.

Other risks: supply chain disruptions, food prices

The harder-to-judge risks come from Russia and Ukraine's integration into global supply chains and their importance in commodity markets.

Russia is a major global supplier of palladium, which is used in the manufacture of motor vehicle catalytic converters. Ukraine provides around 50% of the world's neon gas, which is used in the production of semiconductors, which are also essential in motor vehicle production. Surging motor vehicle prices, due to parts shortages, were one of the important drivers of rising global inflation during 2021. The war could delay the recovery in global automobile production and prevent prices from declining. Ample inventories of palladium and neon, however, should cushion the impact on motor vehicle and semiconductor production.

Rising food prices, however, could be a significant risk. Russia and Ukraine supply around a quarter of the world's wheat exports. Prices have surged 50% since the start of 2022. Much of this supply goes to emerging markets in the Middle East and Africa. Food prices are an issue for inflation but are also a risk for political stability in many emerging economies.

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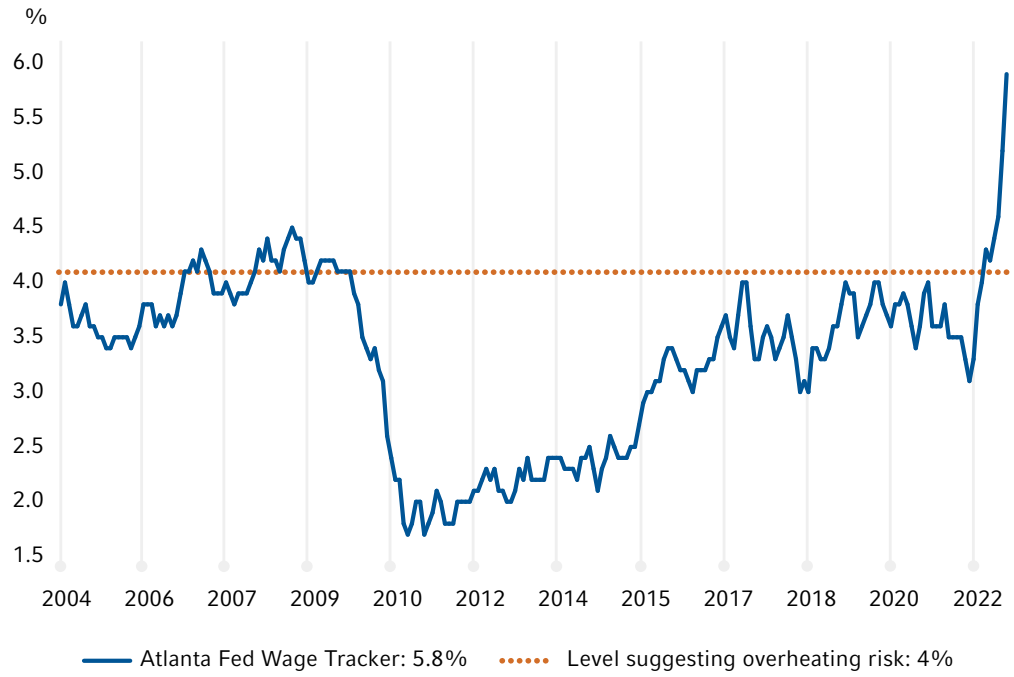
Central banks: higher inflation vs. slower growth

Supply-side-driven inflation shocks are challenging for central banks. They want to sound concerned about the longer-term inflation implications of commodity price rises in order to anchor longer-term inflation expectations, but they also need to proceed cautiously with interest-rate increases because of the potential impact on growth.

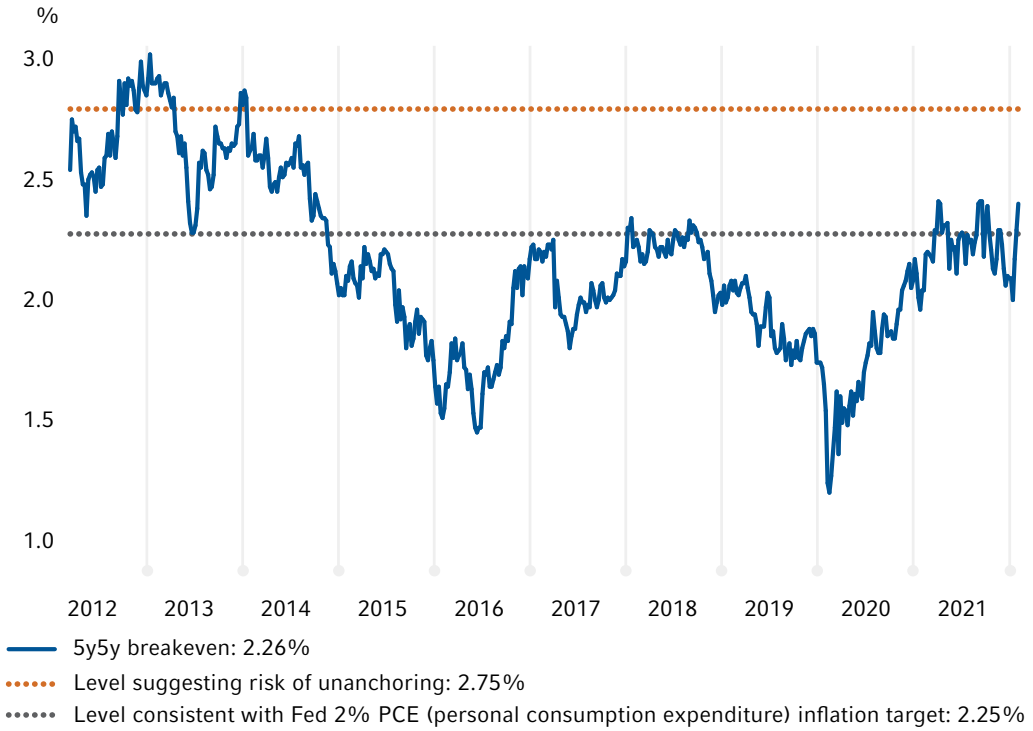
Fixed income markets expect the Fed will lift rates a further six times in 2022. The U.S. economy is the closest to full capacity and least affected by Russia/Ukraine. We agree the Fed will keep hiking policy rates back toward a neutral setting of around 2.25%. The two indicators we have been watching for Fed action continue to provide conflicting signals. The Atlanta Fed's wage growth tracker highlights the labor market pressures from the post-lockdown reopening. The five-year/five-year breakeven inflation rate, which measures investor expectations for the five-year average inflation rate in five years' time, is still well contained. Surging wages point to more rate hikes this year, but well contained longer-term inflation expectations mean the Fed might not need to go too far into restrictive territory.

Atlanta Fed's wage-growth tracker shows surge



Source: Refinitiv® Datastream® as of February 22, 2022.

Longer-term U.S. inflation projection appears well-contained



Source: Refinitiv® Datastream® as of March 16, 2022.

The eurozone economy is further from full capacity than the U.S. and faces a bigger economic hit from Russia/Ukraine. This means the European Central Bank will focus on growth risks more than inflation. Markets expect two rate hikes this year, but it's likely that rates will remain unchanged or only rise once as higher energy prices slow economic growth.

Labor market conditions are tighter in the UK than Europe (in part due to Brexit) and energy prices are threatening to keep headline inflation above 6% by the end of the year. Household disposable incomes are set to be depressed in April by the 1.25% increase in the national insurance levy and 54% increase in the energy price cap on household gas and electricity bills. The market expects the Bank of England to tighten a further five times this year, but pressure on households could limit this to two or three moves.

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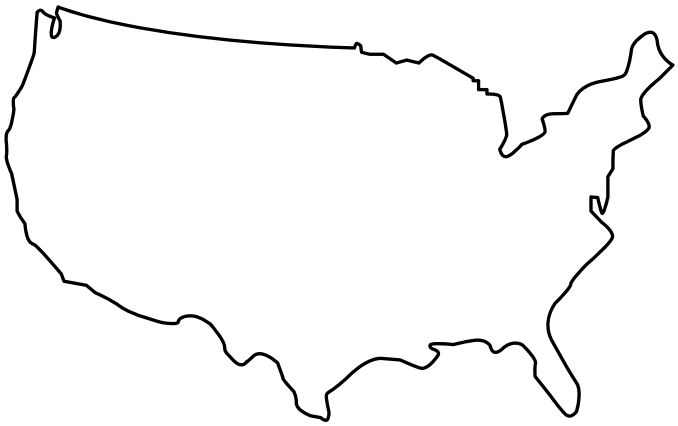
Longer-term implications of the invasion

1. **Less globalization.** The backlash against globalization started with the financial crisis in 2008. It gained pace with former U.S. President Donald Trump's trade wars and was delivered a further blow by the COVID-19 pandemic. The risks to global supply chains caused by the invasion will trigger a further decline in global trade as a share of GDP. Less globalization means less global competition, fewer productivity gains, more inflationary pressure and lower global growth.
2. **More geopolitical risk.** The invasion has highlighted global political fault lines. Russia's no limits partnership with China puts the focus on the U.S./China relationship. The severity of the economic sanctions on Russia likely will deter China from pursuing its claims over Taiwan anytime soon, but ongoing tensions will be a continuing watchpoint.
3. **An accelerated clean-energy transition.** The one positive from the Ukrainian tragedy may be an extra impetus to the move away from fossil-fuel dependence. The European Union plans to be 2030, with energy-saving measures and more of a role for wind and solar. China, in turn, can use discounted Russian natural gas to lower its coal dependency.

Regional snapshots



United States

A rapid labor market recovery and broadening wage and price pressures are forcing the Federal Reserve to pivot monetary policy toward a neutral stance faster than we previously anticipated. The shift to higher interest rates—without commensurate upgrades to economic and earnings growth—hit equities in Q1, particularly longer-duration[2] growth companies. The good news is that with hikes now priced for every remaining Fed meeting in 2022, this risk factor for markets is maturing.

The war in Ukraine has injected further uncertainty for the outlook, but the United States should be among the most resilient economies globally, given its energy independence and its lower share of commodity consumption in GDP. More broadly, the business cycle is rapidly maturing. The labor market is tight, and the Fed is on a path to more restrictive monetary policy. That means recession risks are gradually increasing from the rock bottom levels we estimated earlier in the recovery. 2022 still looks to be a year of above-trend growth, though, as strong household and corporate balance sheets keep the economy on firm footing for now.

Eurozone

The invasion of Ukraine has upended the outlook for the eurozone, which was on track for stronger economic growth than the U.S. market. Inflation pressures were lower than in the U.S., COVID-19 lockdowns were easing and the outlook for corporate earnings growth was supportive for equity-market returns. The invasion has created significant uncertainty. The main risk comes from energy prices, given the region's dependency on Russian natural gas and oil. A decision by Russia to shut down energy exports to Europe, or by European governments to boycott Russian energy, could trigger a recession. This seems unlikely given Russia's need for oil and gas revenues and Europe's reliance on Russian energy. It can't, however, be ruled out.

A short-lived shock to energy prices should see European economies recover in the second half of 2022. 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.

[2] Long-duration refers to companies with cash flows that are expected farther out, generally technology and companies with high expected future earnings growth rates.

United Kingdom

The UK economy began the year with strong momentum, but is likely to be on a slowing path due to Bank of England (BoE) tightening, high energy prices from Russia's invasion of Ukraine and a planned national insurance levy increase (effectively a tax hike) to help fund the National Health Service. It's possible the government will loosen fiscal policy and/or delay the tax hike because of the energy price headwinds, but this is unlikely to prevent the economy from slowing. The BoE has lifted its base rate three times to 0.75%. Fixed income markets anticipate a further four to five rate hikes this year that would take the base rate to near 2.0%. This would be a further blow to household finances since most mortgage interest rates are linked to the base rate.

Despite concerns around the economy, the FTSE 100 Index has been one of the better-performing equity markets this year. Most of the companies within the index generate their revenues outside of the UK. The FTSE 100 has high exposure to commodity prices and financial stocks that benefit from higher interest rates and almost no exposure to under-pressure technology stocks. The index is the cheapest of the major equity markets and offers a dividend yield of 3.75% as of March 2022.

Japan

The Japanese economy has disappointed relative to expectations thus far in 2022. While we still expect above-trend growth, the conflict in Ukraine and the zero-tolerance lockdowns in China have added to headwinds. Japan is an importer of energy products and food and is exposed to higher prices from the conflict. China follows only the U.S. as Japan's second-largest export market. Any disruption to Chinese activity will have a flow-on effect to the Japanese economy. The Bank of Japan is still a long way from raising interest rates, with the inflation rate in Japan currently less than 1%. Japanese equities look slightly less attractive than other non-U.S. markets (namely, Europe and the United Kingdom) on valuations, while the Japanese yen looks outright cheap.

China

The Chinese government recently announced an above-expectations 5.5% GDP growth target for 2022. The economy, however, continues to face pressures, and we expect that significantly more stimulus will be required to get close to the growth target. COVID-19 still poses a challenge to the Chinese economy with the government's zero-tolerance approach. A recent outbreak has seen lockdowns in Shenzhen and parts of Shanghai, both of which are economically important. These will pose short-term challenges to the electronics supply chain (Shenzhen is responsible for a lot of iPhone production). The property sector is still in a precarious position, with sales volumes weak and property developers' credit showing signs of stress. Given the emphasis on economic stability in the lead-up to the National People's Congress at the end of the year, we anticipate there will be more easing measures from the People's Bank of China, including an interest rate cut, and more fiscal spending in the form of infrastructure spending.

Canada

Canada stands to benefit from rising commodity prices, particularly energy prices. Our 2022 GDP growth forecast is unchanged at 3.8%, but accelerating commodities inflation adds uncertainty to this outlook. The Bank of Canada (BoC) has begun rate normalisation, raising its overnight target rate by 25 basis points in March to 0.50%, and has signaled additional hikes are forthcoming. Markets are pricing a further six to seven hikes in 2022, which may seem justified considering the headline inflation rate is approaching two times the upper band of the BoC 1% to 3% range. Household debt, however, has risen since the pandemic and households are now more susceptible to aggressive rate hikes. We think this will make the BoC more measured in its approach, potentially hiking an additional three to four times this year.

Australia and New Zealand

Australia is in the early stages of reopening, with most pandemic restrictions removed. Although there could be a slight drag on household consumption from higher energy prices, Australia is a large exporter of natural gas, coal, and wheat – and its economy stands to benefit from commodity price increases. The labor market has tightened over the last three months, but wage growth has remained reasonably contained. This allows the Reserve Bank of Australia (RBA) to be more patient than many of its global counterparts. We think the market pricing for RBA interest rate rises is too aggressive but expect that the RBA will raise rates at least once this year. The 2022 Australian federal election is due to be held by May 21, with the potential for more fiscal stimulus (aimed at households) as the incumbent Morrison government tries to overcome its deficit in published opinion polls.

The New Zealand economy is similarly in the process of reopening after the disruptions in the second half of 2021 from COVID-19 policy. International borders are about to open to vaccinated visitors, which should provide a boost to the services side of the economy that is reliant on tourism. Commodity price rises are likely to hit New Zealand harder than Australia, given it is an energy net importer. The housing market is likely to weaken further through 2022 as rising mortgage rates take effect. We expect the Reserve Bank of New Zealand will continue to be one of the more aggressive central banks globally.

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Asset-class preferences

Our cycle, value, and sentiment (CVS) investment decision-making process still scores U.S. equities as expensive. The UK and emerging markets are at fair value and Europe is only marginally expensive after the recent market declines. The hard-to-value Japanese market also scores as slightly expensive.

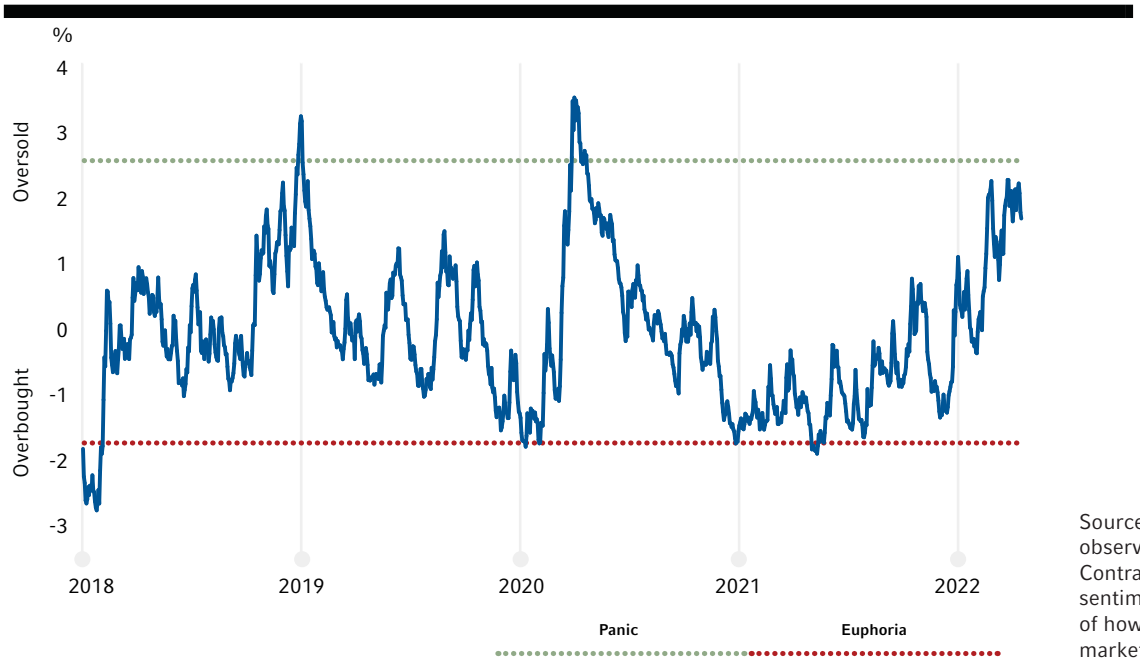
The Russia/Ukraine war has increased the risks and uncertainty around the cycle outlook. On balance, we still expect the cycle to be supportive for global equities and remain a headwind for government bonds. In our 2022 Global Market Outlook report, we commented that above-trend growth and higher long-term interest rates would favor cyclical and value stocks over technology and growth stocks. The rest of the world, particularly Europe, is overweight cyclical value stocks while the U.S. has a higher weight to technology stocks. The war has complicated this outlook due to downgrades to the European outlook and higher commodity prices. Even so, cyclical/value stocks have outperformed so far this year. The case for further outperformance is now weaker, but there could be more gains should hostilities ease and the European growth outlook improve in the second half of the year.

Russia/Ukraine has added to the challenges facing emerging markets (EM). China's economy was already under pressure from the real estate downturn and weak credit growth. This has been made worse by the shutdown of major cities due to the zero-tolerance COVID-19 policy, and has been further exacerbated by surging energy and commodity prices. The MSCI China index has taken a beating on worries that the regulatory crackdown on technology firms may not have ended. Broader EM faces the difficulties of Fed tightening, a stronger U.S. dollar (USD), rising food prices and more expensive energy. EM could stage a turnaround if, as seems likely, China undertakes significant stimulus and commodity prices pull back on easing hostilities in Ukraine. For now, however, a neutral stance is warranted.

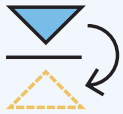
The U.S. dollar has made gains this year on Fed hawkishness and its safe-haven appeal during times of global conflict. Currencies such as the euro and the yen now appear significantly under-valued on a longer-term basis. The uncertainties around the outlook are large, but there is a case for USD weakness in the second half of the year if Russia retreats from Ukraine and the Fed becomes less hawkish as inflation pressures lessen. Dollar weakness should support the performance of non-U.S. markets and will help offset some of the headwinds facing emerging markets.

Sentiment for equity markets is firmly oversold but not yet at the level of panic reached in late 2018 and early 2020. The cycle uncertainty means we are looking for clearer signs of market panic before recommending a risk-on stance.

Composite contrarian indicator: Sentiment for equity markets still below panic level



Source: Russell Investments. Last observation: March 17, 2022. Contrarian indicators for investor sentiment give a numeric measure of how pessimistic or optimistic market actors are through time.



Despite Russia's invasion of Ukraine, we have a small preference for **non-U.S. developed equities** to U.S. equities. Provided hostilities subside, above-trend global growth should favor relatively cheaper non-U.S. markets.

Emerging market (EM) equities face headwinds from the China slowdown, high energy and food prices as well as central-bank tightening across other EM economies to contain inflation pressures. EM equities could recover if there is significant China stimulus early in the year, the Fed slows its pace of tightening, energy prices subside, and the U.S. dollar weakens. For now, a neutral stance is warranted.

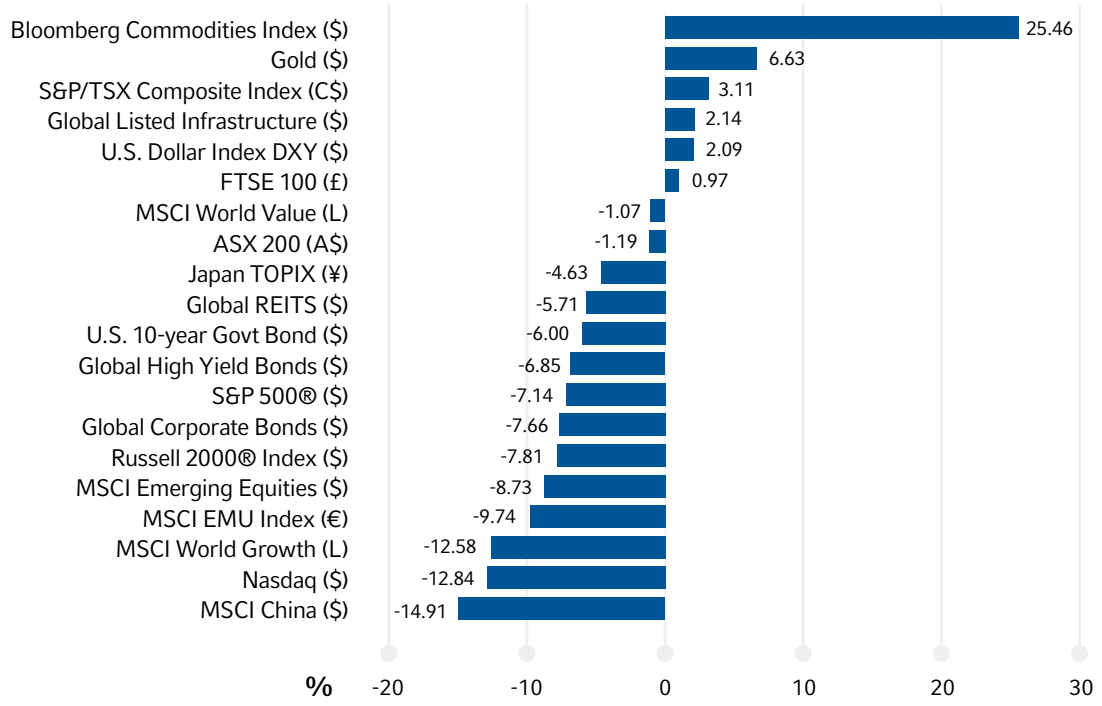
High yield and investment grade credit spreads widened following the Russian invasion of Ukraine. The investment grade spread is back to its longer-term average, but the high yield spread is still low by historical standards. High yield spreads will be at risk if the Russia/Ukraine conflict escalates but could perform well if hostilities subside and the cycle outlook improves. Given the uncertainties, we have a neutral outlook on credit markets.

Government bond valuations are mixed after the recent selloff, with U.S. now fairly valued and Japanese, German and UK bonds still expensive. Yields will face upward pressure from continuing inflation increases and central-bank hawkishness. A positive for government bonds is that markets have fully priced potential tightening by 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 posted negative returns. Both should benefit if Russia/Ukraine hostilities subside, the pandemic recovery resumes and inflation concerns continue, although GLI should give back some of the gains from energy infrastructure. **Commodities** have been the best-performing asset class, with energy and agricultural prices surging on the Russia/Ukraine conflict. Some of these gains will be reversed if hostilities subside, but strong global demand and supply bottlenecks should support prices. The prices for many commodities futures are now below the current price (known as backwardation) after many years when the reverse was the case. Backwardation provides an interest-rate like return for investors in commodities funds. One risk for commodity markets is that Chinese economic stimulus is too small to prevent a further slowdown. On balance, the case for commodities exposure is still positive.

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 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.

Asset-class performance since the beginning of 2022



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

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IMPORTANT INFORMATION

The views in this Global Market Outlook report are subject to change at any time based upon market or other conditions and are current as of March 28, 2022. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Keep in mind that, like all investing, multi-asset investing does not assure a profit or protect against loss.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Russell believes that the utility of this information is highest in evaluating the relative relationships of various components of a globally diversified portfolio. As such, the models may offer insights into the prudence of over or under weighting those components from time to time or under periods of extreme dislocation. The models are explicitly not intended as market timing signals.

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

Investment in global, international or emerging markets may be significantly affected by political or economic conditions and regulatory requirements in a particular country. Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation. Such securities may be less liquid and more volatile. Investments in emerging or developing markets involve exposure to economic structures that are generally less diverse and mature, and political systems with less stability than in more developed countries.

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Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation.

Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to sub-prime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a Fund's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

Performance quoted represents past performance and should not be viewed as a guarantee of future results.

The FTSE 100 Index is a market-capitalization weighted index of UK-listed blue chip companies.

The MSCI EMU Index (European Economic and Monetary Union) captures large and mid cap representation across the 10 developed markets countries in the EMU. With 246 constituents, the index covers approximately 85% of the free float-adjusted market capitalization of the EMU.

Indexes are unmanaged and cannot be invested in directly.

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UNI-12012