Russell Investments

Q2 2023

LONG AND VARIABLE LAGS

GLOBAL MARKET OUTLOOK

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SYNOPSIS

Growth has been resilient, but inflation is receding only slowly, and central banks have not finished tightening. Meanwhile, recession indicators are still flashing warning signals. In our view, this creates a positive backdrop for government bonds and uncertainty for equity markets.

KEY MARKET THEMES

Economist Milton Friedman famously noted that “monetary actions affect economic conditions only after a lag that is both long and variable.” The current cycle is following this maxim. We’ve seen the most aggressive tightening by the U.S. Federal Reserve (Fed) since the early 1980s, yet payroll gains have averaged 407,000 over the first two months of this year and consumer spending growth is running close to trend. European and Chinese growth have also surprised positively.

It would be unwise, however, to sound the *all-clear* on the global growth outlook, as those long and variable lags are still in play. Historically, it has taken an average of around two and a half years after the Fed’s initial rate hike for a recession to commence—and the first hike in this cycle was in March 2022.

The collapse of Silicon Valley Bank (SVB) in mid-March highlights the dangers from aggressive central bank hikes. SVB’s main problem was its large holding of long-duration bonds, which lost value as bond yields rose through 2022. The economic data renaissance combined with the threat of financial sector instability leaves central banks with difficult choices.

In the U.S., we believe a recession is likely over the next 12-18 months. However, we expect that strong household and corporate finances will likely keep the downturn mild in scope. A mild recession, however, does imply that the cycle will be a headwind for equity markets as earnings and economic indicators deteriorate. This would likely lead to a more favorable environment for government bonds, however.

Eurozone economies have surprised with their strength and avoided a recession that seemed inevitable late last year. The mild winter in Europe has reduced energy

demand and lowered energy prices, and a range of economic indicators have positively surprised. The sting in the tail from better economic growth is that the ECB has taken policy into restrictive territory. Case-in-point: The central bank recently lifted its policy rate by 50 basis points to 3.0%, and at least one more rate hike is possible.

The UK economy, like the rest of Europe, is performing better than expected, and a recession is no longer anticipated in the near-term. Medium-term headwinds are still in place, however, from rising interest rates and a tight labor market that is generating wage growth that is too high to bring inflation back to the Bank of England (BoE)’s 2% target.

In China, the country’s economy is reopening after years of COVID-19 lockdowns. The government has announced a gross domestic product (GDP) growth target of *around 5%*, which is in line with our expectations. We believe that growth this year will be reliant on the consumer, given the slowing global economy and the Chinese government’s preference to not let property construction aggressively expand.

Japan is still on track for modest growth this year, as soft domestic and global demand is offset to some extent by the proximity to China’s reopening. The key issue for the Japanese economy is wage growth, and the potential for inflation to sustainably reach the Bank of Japan (BOJ)’s 2% target.

In Australia, we believe that growth should continue to slow through 2023, although we see recession risks as lower than in the Northern Hemisphere. While the country’s labor market is very tight, we think it is likely to ease through 2023 as demand moderates and supply increases as immigration resumes.

In Canada, the economy has performed better than expected, supported by exports and domestic demand. Undoubtedly, the resiliency of the U.S. economy has benefited trade, while a milder winter has boosted consumer spending.

ECONOMIC VIEWS

U.S. LABOR MARKET

We estimate that the U.S. unemployment rate—at 3.6% in February—needs to rise by at least a percentage point to generate the cooling in wage growth required by the Fed.

CHINA FISCAL POLICY

We believe that fiscal policy in China will be less supportive for the economy than last year. The government has announced that the augmented fiscal deficit (the central government plus the local government financing vehicles) will modestly tighten this year.

EUROZONE OUTLOOK

China is an important export market for the eurozone, and its reopening should provide a further boost for the region's economies, particularly Germany and Spain.

EARNINGS GROWTH EXPECTATIONS

We believe the current round of surprisingly strong economic data could see earnings growth expectations track broadly sideways for the next few months.

BANK OF ENGLAND COULD PAUSE RATE HIKES SOON

Markets expect one more 25-basis-point tightening that will take the UK's policy rate to 4.25%. The BoE then seems likely to go on pause ahead of the Fed and ECB.

ASSET CLASS VIEWS

Equities: Limited upside

We believe equities have limited upside with recession risks on the horizon. Although non-U.S. developed equities are cheaper than U.S. equities, we have a neutral preference until the Fed become less hawkish and the U.S. dollar weakens.

Fixed income: Improved valuations for government bonds

We see U.S., UK and German bonds as offering reasonable value, while Japanese bonds still look expensive, with the BOJ holding the 50-basis-point yield limit. In our view, the risk of a significant selloff seems limited, given inflation is close to peaking and markets have priced hawkish outlooks for most central banks.

Currencies: Strong U.S. dollar could weaken later this year

The U.S. dollar has risen modestly this year on Fed hawkishness, but we think it could weaken if inflation begins to decline and the Fed pivots to a less hawkish stance. The main beneficiaries of this would likely be the euro and the Japanese yen. The yen could also appreciate strongly if new BOJ governor Kazuo Ueda moves away from the current *yield curve control* strategy.

Please visit:

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IMPORTANT INFORMATION

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

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