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By John Vail
Chief Global Strategist

GLOBAL INVESTMENT COMMITTEE'S OUTLOOK: STAGFLATION-LITE, CAUTIOUS ON BOTH EQUITIES AND BONDS, EXCEPT POSITIVE ON PACIFIC EQUITIES

Global economic recovery slightly below consensus, with inflation above consensus

In our early December meeting, we, thinking that cooler heads would prevail, did not foresee the Ukraine crisis and the ensuing market conniptions. Somewhat oddly, however, our strong preference for global equities and negative view on global bonds was justified, with the latter sinking very sharply in USD terms, while the former actually rose about 2%. We expected GDP growth for the G-3 and China in the four quarters ahead to match consensus, but now consensus for that period is much lower. Due to the crisis, we also greatly underestimated how much commodity prices and bond yields would rise.

Looking forward in obviously murky conditions, on 30 March, out of the six macro-economic scenarios presented, our committee nearly unanimously agreed on a scenario in which the global economy continues to struggle in a form of "stagflation-lite": slightly below market consensus of moderate G-3 GDP growth with inflation higher than consensus, coupled with geopolitical disruption that does not improve, but does not worsen much either. Included in the latter factor, we expect hacking to become more problematic, but we do not expect financial stability to be much disrupted by any of these negative factors.

Given this scenario, we expect corporate guidance in April's earning season to be quite cautious, with global demand decelerating while margins are being squeezed by higher labour and other input costs. Supply chain disruptions should continue to burden profitability too. We have said for years that no one should doubt the ability of US corporations, in particular, to boost profits, but the quarters ahead should be especially challenging. **Investor sentiment, meanwhile, will likely remain cautious, especially as we expect last week's hopes for a much smoother path for the Ukraine conflict to be overly optimistic.** Investors will also face the macro-economic and geopolitical worries mentioned above. **Based on this backdrop, our fixed income and equity teams delivered targets that estimate relatively flat performance for global equities in aggregate for the next three to six months (although quite positive on Pacific equities), with moderate weakness for global bonds.** We expect commodity prices to rise further, but not wildly so, and that central banks will be moderately more hawkish than they already are.

Our new scenario predicts that globally, GDP will underperform consensus, with the US up 1.3% at a Half on Half Seasonally Adjusted Annualized Rate (HoH SAAR, as used in all references below) in the 2Q22-3Q22 period and 1.8% in the 4Q22-1Q23 period (vs. consensus of 1.5% and 2.5%, respectively). Personal consumption should recover, especially for auto sales and the re-opening services sectors, while private capex should continue to improve in most sectors, especially technology. However, construction spending outside of the infrastructure sector will likely be constrained, while government spending should show subdued growth and net foreign trade will likely subtract significantly from GDP growth.

Eurozone GDP is clearly hurt the most by the Ukraine crisis and should grow only 0.2% in the 2Q22-3Q22 period and 1.4% in the 4Q22-1Q23 period (vs. consensus of 0.6% and 2.8%, respectively). **Japan's economy** should benefit from re-opening, but commodity price hikes should push growth down to 1.3% in the 2Q22-3Q22 period and 1.1% in the 4Q22-1Q23 period (vs. consensus of 2.2% and 2.0%, respectively).

On China's economy, we continue to expect it to be able to wade through the current troubles, although it should be quite rocky at times. The recent lockdowns will negatively affect both domestic and global growth, especially when considering the supply chain disruptions that will likely occur as a result. The January and February macro-economic data seemed to overstate growth, which we expect was actually quite poor, but in the 2Q, there should be a decent rebound. We continue to note that major shifts in economic policy often cause problems and the property market's weakness is causing broadly negative effects in both the economy and financial system (which is extremely opaque and complicated, yet crucially important). The government is aware of the problems and is, thus, reducing regulatory pressure somewhat and patching up various problems, but they will likely maintain the course away from property-driven nation.

Meanwhile, the regulatory crackdown on various sectors aims to reduce inequality and veer the culture away from trendy (usually foreign, including Asian) and gaming cultures. Growth in the social media sphere will be moderately curtailed for an indefinite period, but will still likely continue, nonetheless. Meanwhile, China is promoting super-high technology fields so as to achieve self-sufficiency in semiconductor production equipment (which will be extremely difficult, as no country has ever achieved such) and other areas where China already has achieved prowess like AI, systems integration and the medical industry. It will also likely try to keep as much foreign business involvement as possible (as long as such does not get political), as such will be needed to support the economy. In sum, we forecast its GDP to grow 4.0% HoH SAAR in the 2Q22-3Q22 period and 4.5% in the 4Q22-1Q23 period (vs. consensus of 4.9% and 5.7%, respectively).

For full year 2022 growth, GDP for the US, Eurozone, Japan and China, at 2.7%, 2.2%, 1.0% and 4.1% respectively, should underperform consensus of 2.9%, 2.5%, 1.5% and 4.5%, and one should note that these numbers are boosted by low base effects (especially Europe), so they are weaker than they appear.

Geopolitics will no longer be ignored

Whereas in the past the problems were fleeting, geopolitical issues should now remain something that markets will not ignore. Not only will Ukraine continue to be a major problem, North Korea, China and the Middle East need watching. On Ukraine, although fighting might lessen, Russia likely wants control over a large part of eastern Ukraine, which will likely never be granted; thus, a peace treaty is very unlikely. Grey-zone warfare with Ukrainian forces and with the rest of the world, including hacking, will continue to disrupt markets, economies (especially as Ukraine and Russia are such large commodity producers that affect supply chains and inflation) and investor confidence. Relations between the West and China remain very tense, and neither side seems willing to cross any red lines, but on top of all the other items, China's support of Russia despite Western sanctions has the potential for major economic disruptions with the West. Increased fears about Taiwan certainly should not be ignored either. Meanwhile, the Middle East remains on tenterhooks, especially whether the Iran deal will be completed, although we believe, it will be, especially after this week's Saudi announcement of a ceasefire through Ramadan. This should lay the groundwork for a durable truce with the Houthis, which may in turn reduce Iranian support for the Houthi's attacks on Saudi and UAE infrastructure, and, thus, gain support for the US to make the final compromises to complete the deal. Besides capping Iran's nuclear ambition, the US's overwhelming incentive is to boost Iranian oil output.

As for US political risk, the country remains mired in conflict, but we still expect a moderately-large (although mostly neutral-cost) fiscal stimulus bill to be achieved via the "reconciliation" method. Social issues may also provoke civil unrest, especially leading up to November's election, after which the outlook points to complete political stalemate. If, as seems likely, the Republicans win one or both houses, investigations into Democrats, including President Biden, will likely prove unsettling. The net result of all of this, especially if such includes tax hikes, should make risk markets and business leaders wary in some US sectors, but such will likely boost the economy in other sectors, particularly in the new energy and technology fields.

Our detailed forecasts:

Scenario 2	Mar 23 2022	Jun 2022	Sep 2022	Dec 2022	Mar 2023
JP Uncollateral Call	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%
US FF Rate	0.50%	1.25%	1.75%	2.25%	2.75%
ECB Policy Rate	-0.50%	-0.50%	-0.50%	0.00%	0.50%
UK Policy Rate	0.75%	1.50%	2.00%	2.25%	2.50%
JP 10Y Bond	0.23%	0.25%	0.30%	0.35%	0.40%
US 10Y Bond	2.29%	2.50%	2.60%	2.70%	2.70%
Euro 10Y Bond	0.48%	0.60%	0.70%	0.75%	0.75%
UK 10Y Bond	1.64%	1.80%	1.90%	2.00%	2.00%
AUD 10Y Bond	2.72%	2.90%	3.00%	3.10%	3.10%
USD/JPY	121.10	122.00	123.00	121.00	120.00
EUR/USD	1.10	1.08	1.07	1.09	1.10
GBP/USD	1.32	1.30	1.30	1.30	1.30
AUD/USD	0.75	0.75	0.76	0.76	0.76
SPX	4456	4458	4577	4483	4554
Euro STOXX	431	400	390	380	375
FTSE	7461	7150	7000	6800	6800
TPX	1979	2050	2090	2050	2020
Nikkei 225	28040	29000	29500	29000	28500
Hang Seng	22154	23262	23816	25477	24369
ASX	7378	7450	7550	7550	7550
Oil Brent	122	125	135	140	145
Gold	1943	2050	2100	2150	2200
BBG Commod (DJ UBS)	129	135	140	145	150

Central banks: moderately more hawkish than consensus

We expect the Fed to hike 50 bps in May and 25 bps in all following meetings through 1Q23, coupled with QT moderately faster than consensus. As for the ECB, we expect it to end QE soon and hike 25 bps twice in both the 4Q22 and 1Q23. Meanwhile, the BOJ in the 2H22 is likely to either widen the 10-year band or shorten the target to five years, while hinting at 2023 hikes. If the yen substantially weakens further, these actions could happen sooner rather than later. In sum, although this hawkishness may give global markets indigestion for a while, policy will remain rather accommodative and should narrowly prevent recessions, although it will allow for inflation to remain more stubborn than expected (stagflation-lite). One should note that 30-year fixed mortgage rates in the US have soared to near decade-highs, presenting a major headwind to the crucial residential and commercial property markets. Depending on inflation expectations, however, homebuyers may believe that home prices can continue rising, like they did in the 1970s (full-blown stagflation), despite rising interest costs.

Moderately increasing G-3 bond yields, USD somewhat stronger until return to flat

For bonds globally, relatively weak economic growth should offset higher than expected inflation, but Fed QT certainly will prove challenging. Even if inflation remains high, many bond investors, given their disposition, will likely assume that inflation will decelerate sometime in the future, so we don't expect yields to surge. Bond investors will also worry about virus scares, especially disappointing economic data points, geopolitical flare-ups and problems during China's transition. For US 10-year Treasuries, our target for end-June is 2.50%, while those for 10-year Bunds and 10-year JGBs are 0.60% and 0.25%, respectively, mildly rising at year-end to 2.70%, 0.75% and 0.35%. Regarding forex, we expect the USD to hit 122 vs. the yen in June and 121 at year-end, while it should also mildly strengthen vs. the euro to 1.08 and 1.09 for those periods. After that, the USD should return to flat vs. present levels.

This all implies that the FTSE WGBI (index of global bonds) should produce in USD terms a -2.1% unannualized return from our base date of 23 March through June and -2.8% through year-end. Thus, we continue our unenthusiastic stance on global bonds for USD-based investors. For yen-based investors, this index in yen terms should return -1.4% and -2.9%, during those respective periods, with JGBs returning -0.2% and -1.0%, respectively, so offshore bonds look worse relative to JGBs.

The Brent oil price should remain on an upward path in our view given that Russian oil and gas cannot be fully diverted to other buyers. There also remains a large possibility that Russia will reduce its supplies due to "accidents" similar to the very long repair time (due to sanctioned Western equipment needed) of one of its storm-damaged Caspian platforms that accounts for 1-2% of global supply. Payment problems, including Russia's demand to be paid in rubles for oil, will also prove a challenge. Furthermore, damages to natural gas pipelines through the Ukraine are ultimately likely, as well. Meanwhile, the Iran question looms large, both geopolitically and as regards global oil supply, but we expect that a deal will offset part of Russia's cutbacks. The Brent price has declined since we set our targets on the 23 March, but we expect it to rebound to USD 125 in June and USD 140 at year-end.

After a major surge in March's data, we expect that headline and core CPI measures for the next few quarters will decelerate on a YoY basis, although not as much as consensus expects. For the US headline CPI, we expect 6.2% and 4.6% in September and March 2023, respectively, vs. consensus of 5.8% and 3.2%. For the US core CPI, we expect 4.8% and 3.6% in September and March 2023, respectively, vs. consensus of 4.6% and 3.0%. Housing rent, food, gasoline, airfares, auto services and re-opening services should continue strongly upward, but new and used car prices should decline more fully quite soon as production resumes. These rates remain well above the Fed's target even assuming the PCE deflators are a bit lower than the CPI. The Fed will also increasingly realise that while targeting headline inflation, as opposed to core, is difficult, such is the measure that citizens (and voters) care most about and that Fed policy affects energy and food prices both through aggregate demand and the inflation psychology of commodity speculators and users.

Global equities flattish in aggregate, but positive for Asia-Pacific

Despite everything, including rather lackluster guidance during the 4Q earnings season, the MSCI World Index rose nearly 2% (unannualized in USD terms) from our base date until our meeting this week, vs. our 5.3% forecast. **Our new scenario forecasts relatively flat returns for global equities in aggregate for the two quarters ahead.** Along with even more hawkish central banks, the possibility of moderately higher taxes ahead for the wealthy (and perhaps for all equity investors too) in the US will hamper investment sentiment, as will higher US corporate taxes ahead via a reconciliation bill. Moreover, **we expect corporations globally to guide very cautiously during the 1Q earnings season** as input costs surge and they finally experience demand curtailment due to higher prices. The continued re-opening of the global economy should prevent a corporate earnings downturn, however, except in the Eurozone. Geopolitical events that hurt market sentiment and proper economic functioning should also curtail equities globally. One other thing to note is that EPS growth globally was artificially high in 2021 due to releases of bank credit reserves, which should disappear in 2022, thus making 2022 EPS growth look artificially low.

In sum, we shift to an unenthusiastic view on global equities. Aggregating our national forecasts from our base date, we forecast that the MSCI World Total Return Index in USD terms will be -0.3% through June, 1.9% through September and 0.6% through December (0.4%, 3.5% and 0.6% in yen terms). **However, most of the sluggishness comes from large declines in Europe and low US returns, while we expect quite positive returns in Japan and Pacific ex Japan** (our coverage is only for developed markets).

In the US, the SPX's PER on its CY22 EPS estimate is now about 20, which remains, by historical standards, quite high. Rising fixed income yields will greatly challenge valuations, but buybacks remain strong and CY22 earnings growth should at least be positive YoY (although not guided up as usual, and even possibly guided downward). In sum, this should lead to a mild de-rating and somewhat flat equity returns. Government intervention, especially among major tech stocks, is also likely to be a headwind now that the DOJ has supported the bipartisan Congressional anti-trust bill. In sum, we expect the SPX to remain flat at 4,458 (0.4% total unannualized return from our base date) at end-June, 4,577 at end-September (3.5% return) and 4,483 at end-December (1.7% return), with yen-based returns of 1.2%, 5.1% and 1.6%, respectively.

European equities have not underperformed the US by very much since our December meeting, which seems far too positive given Europe's strong economic connection to Russia and given our expectation that the Ukraine crisis, and, thus, its many associated troubles, will not improve. Indeed, we expect that a decline of natural gas shipments to Europe, for whatever justification, will be greatly problematic to both sentiment and the fundamentals of the economy and corporate sector. Thus, we expect equities to de-rate and for CY22 earnings growth expectations to shift to negative YoY levels. A weaker EUR in the next six months will hinder USD returns, as well. The Euro Stoxx PER, at 13.9 times CY22 EPS current estimates equates to its historical average, but beyond the valuation de-rating reasons mentioned above, European bond yields are at the same time rising sharply and we forecast that the ECB will be even more hawkish than consensus. Thus, we expect the Euro Stoxx index to fall to 400 at end-June and FTSE to 7150, which translates to a total return of -7.0% (unannualized from our base date) for MSCI Europe through then in USD terms. We project even worse MSCI Europe returns through September, at -9.1%, and at -9.6% through December.

Japanese equities disappointed recently in USD terms. Equities in yen terms have not performed too badly, but the yen has been quite weak, mostly due to the BOJ rightly insisting that sustainable inflation in Japan is not likely yet, and thus it will not tighten policy. Given the full re-opening of the economy (except international tourism) in mid-March, the rebound in consumer optimism should finally occur. The auto sector, which is a major portion of the stock market and economy, has suffered more production troubles than anticipated, but the situation has already sharply improved and should do so greatly further after March.

Corporate earnings continue to rebound and the weaker yen should assist such further. Meanwhile, Japan has low political risk and structural reform is continuing, especially in digitalisation and alternative energy, while existing and future fiscal stimulus should also boost economic growth. Japan's low exposure to Russia is fortunate, although it will be affected to some extent by Europe's deceleration. Meanwhile, China's rebound from lockdowns, though muted, will be particularly beneficial to Japan. TOPIX's PER fell to 13.7 times its CY22 EPS consensus estimate, which is quite low, especially as CY22 earnings estimates in aggregate should remain firm. Also, to support the market are increased share buybacks and the market's dividend yield, which at 2.1% remains attractive vs. bonds. Notably, the market has recently been positively correlated with US bond yields and we expect further increases in such yields to help, rather than hinder the market. Thus, we do not expect any valuation de-rating despite troubling geopolitics. We forecast TOPIX at 2050 at end-June, 2090 at end-June and 2050 at end-December for **total unannualized returns of 3.4% in USD terms (4.2% in yen terms), 5.1% (6.7% in yen terms) and 5.3% (5.3% in yen terms),** respectively, from our base date through those periods. As for the Nikkei, it should hit 29,000, 29,500 and 29,000, respectively. These returns are obviously very attractive for both domestic and global investors.

Developed Pacific-ex Japan MSCI: Australia benefits greatly from higher commodity prices and stable political risk. As long as China does not get greatly penalized for its relations with Russia and the Taiwan situation is stable, China's economy should rebound and its demand for Australian goods should continue to recover, especially as their political spat has subsided. China needs increased coal supplies because it is worried about energy costs and is willing to slow its transition to green energy. Hong Kong's stock market, which is dominated by PRC firms, was hurt by several of China's regulatory developments, as well as Hong Kong's own troubles, including the continued dearth of tourists and weakening property market. However, improvements, however moderate, are occurring and hopefully the Hong Kong property market will be able to withstand higher interest rates. In the meantime, Hong Kong will benefit from China's rebound from lockdowns. In sum, we expect strong gains for Hong Kong over the next six months, and moderately good ones for Australia too, leading to the region's MSCI index in USD terms to rise (total unannualized return) 3.4%, 7.1% and 10.7% through June, September and December, respectively.

Investment strategy concluding view

Stagflation-lite is not a welcoming prospect for global economies and equities in aggregate, especially for Europe. Indeed, the global economy should underperform consensus and achieve only mild growth, mostly due to re-opening. Central banks being even more hawkish than consensus does not help either, especially if this hawkishness does not even stop commodity prices from rising. Warnings about corporate profits should restrain equity markets too, although we are not bearish outside of Europe and are actually positive on Japan and Developed Pacific ex Japan. Meanwhile we expect continued poor returns for global fixed income, so a large weighting to cash-like instruments seems logical. As always, there remains a significant chance of alternate scenarios, for which we have different market and economic targets, and institutional investors are welcome to contact us for such.

Important Information