Mid-year outlook: cooling or freezing?

June 2022

Is it possible to cool inflation without freezing growth? That's the fine line being walked by central banks as investors look to the rest of the year and beyond. We think the economy will slow down significantly and a US recession is likely. Find out how our Global CIOs think the rest of 2022 will play out across asset classes.

Key takeaways

- Inflation, rate hikes, geopolitical conflicts and Covid-19 are among the many factors creating headwinds for the global economy
- The ongoing fragmentation of the "global village" is reducing growth as well – but it's also creating new partnerships and alliances
- For the global economy, we think a "hard landing" in 2023-2024 is more likely than a recession, but in the US, recession risks are notably higher
- Given widespread market uncertainty, investors may want to assemble a broader toolkit to smooth out volatility and take advantage of opportunities as they arise
- Our Global CIOs offer their top equity, fixed-income and multi-asset investment ideas

Macro view: multiple factors are fuelling this economic slowdown

At the start of the year, few predicted the precise confluence of factors that would take their toll on the global economy and financial markets. A strong post-Covid rebound, excess liquidity and continued supply-chain upheaval caused year-over-year inflation to spike. Commodity prices soared with Russia's invasion of Ukraine and the global response. Financial markets suffered amid broad selloffs of both stocks and bonds. Consumer sentiment and spending both weakened, and companies took hits to revenues and earnings. And major central banks – namely the US Federal Reserve – stepped up their efforts to help engineer an economic "soft landing" that would cool inflation while not freezing growth, knowing full well that most previous Fed tightening cycles ended in recessions.

What should investors do next? We think it's important to assemble a broader investing toolkit and find new ways to position portfolios for this environment. Here are select ideas worth considering.

- For equity allocations, quality value stocks, selective high-tech innovators and China equities look attractive. Energy and food security are among the thematic investments worth closer consideration.
- For fixed-income allocations, certain longer-duration sovereign bonds in developed markets are becoming more attractive – less so euro-area peripheral and semi-core bond markets. Also consider adding exposure to certain US high-yield names on any further spread widening.
- For multi-asset portfolios, commodity investments may help guard against rising inflation – and gold in particular may provide better diversification for equities than government bonds.

Deglobalisation is contributing to slower growth and higher inflation

While inflation, rising rates and slowing growth are the key economic themes affecting portfolios today, another topic plays a major role in these areas: the continued rise of deglobalisation and its variants "slowbalisation" and "glocalisation".

International trade as a share of GDP has been declining since the global financial crisis of 2007-2009, and the China-US trade war and Brexit hastened things along. Recently, the supply-chain upheavals caused by Covid-19 made matters worse, particularly in China, where strict lockdown measures slowed not just the spread of the coronavirus, but economic growth. As we know from the experiences of the past two years, Covid doesn't just hurt GDP: the ensuing production upheavals can exacerbate inflation as well. The war in Ukraine has amplified the disruption, with many companies now questioning the reliability of foreign sales and production – and gravitating towards "onshoring" rather than offshoring.

All these factors could lead to a stronger polarisation of economic systems, with the United States and allied nations on the one side, and China and Russia on the other. This fragmentation of the "global village" matters for many reasons, not least because it leads to less trade as a share of GDP, slower growth and higher inflation. However, we don't think globalisation is dead; rather, it's likely to take new forms. For example, the challenges posed by climate change are global in nature, demanding urgent collaboration rather than individual approaches.

Our base-case view at the mid-year point

- We think that within the next two years, the global economy will face a "hard landing" – meaning a state of very slow growth below potential. We also expect a US recession to emerge in 2023-2024.
- While we don't anticipate 1970s-style "stagflation" – a toxic mix of slow growth and recessions in combination with double-digit inflation rates – we expect inflation to continue to surprise on the high side. Year-over-year inflation rates are likely to peak by the end of the year, provided we don't experience another energy price shock, but it will take a long time (at least three to five years, in the view of our senior investors) for inflation to fall back to central banks' targets (usually 2% in the developed markets).
- We don't expect central banks, particularly the Fed, to slow or even interrupt the announced normalisation of monetary policy. Rather, we believe they will continue to increase interest rates and reduce their balance sheets. Will a cooling economy prompt central banks to change course and stop their rate hikes sooner than expected? It's possible. But it seems more likely that high inflation has effectively tied central banks' hands, forcing them to act. To that end, investors shouldn't be surprised if the markets need to price in more monetary tightening, not less (see Exhibit 1).

Challenging environment for financial markets

What does all this mean for financial markets? How will various asset classes react to slower growth and a possible US recession, as well as sticky inflation rates, rising interest rates and a reduction of central bank balance sheets? In the following sections, our Global CIOs offer their insights on the markets for the rest of the year.

Exhibit 1: markets are now pricing in notably higher global policy rates

In June 2022, market expectations called for global policy rates to move about 150 basis points higher within the next two years – a notable increase from the expectations set just six months earlier. We believe investors should make room for the idea that the markets will need to price in more monetary tightening, not less.

Source: Bloomberg. Data as at 1 June 2022.

Viewpoint

Equity strategy: navigating the narrow path of monetary policy normalisation in a synchronised global slowdown

Virginie Maisonneuve
Global CIO Equity

Addressing the "great catch-up" in rates

As we look at the forces at play in the global economy, it appears we're in the midst of a "great catch-up" unfolding at high speed. This is one of the most significant instances of monetary tightening in history, and it's happening in the context of an economic slowdown – a highly unusual combination. Consider what we have witnessed in recent months:

- Major central banks have started to remove record amounts of liquidity by hiking rates and reducing asset-purchase programmes (known as quantitative easing).
- Inflation has soared – particularly energy and food prices – after staying at stubbornly low levels for decades. Central banks are single-minded in their focus on tamping it down.
- The global geopolitical "order" that prevailed for decades has begun to splinter, further fragmenting the global village. Russia's invasion of Ukraine and Covid-related supply-chain woes have prompted more countries and companies to "onshore" and rethink their global supply chains – not only to save on costs, but to build new partnerships.
- As markets process this information, yields on benchmark bonds have pushed higher and major equity indices have dropped significantly, ending a long run of strong performance.

Here at the mid-year point, we are watching QE withdrawal and rate increases in a world that is slowing, not growing – which is very atypical. Given this backdrop, the question for investors is: where is this great catch-up headed? Global trade as a share of GDP could fall further, pressured by a strong US dollar and difficulty sourcing goods. Interestingly, many companies in the US that have managed to repair their supply chains are now grappling with growing inventory levels as consumers pare back spending. This may indicate a slowdown in demand to come.

Could inflation soon peak? Consider M2, which measures US money supply and has historically been a good indicator of inflation and growth after a 12- to 18-month lag. This metric topped out in February 2021 (see **Exhibit 2**), which suggests that inflation could max out in the next six months. The probability of a strong, synchronised global economic slowdown is supported by M2 data and other indicators. (These include the high price of oil, falling manufacturing indices, rising interest rates and the reversal of the economic support

Exhibit 2: falling US money supply suggests inflation may drop as well

The metric M2 – which measures an economy's supply of money, including cash and checking deposits – has historically provided an indication of where inflation might be in 12-18 months. In the US, M2 has fallen notable since its February 2021 high, suggesting that inflation may soon be on its way down.

Source: Federal Reserve Bank of St Louis. Data as at 1 April 2022.

Equity strategy

(continued)

packages put in place during the height of the pandemic.) The impact of slowing growth on corporate margins and earnings has yet to be reflected in many companies, and while valuations have already adjusted considerably, an upcoming "earnings recession" is still a possibility.

Solutions for positioning equity portfolios in this environment

The inflection point for equity markets could come when the expectations for US rate hikes shift from 50 basis-point "leaps" to 25 bps or zero. This may be the time when "bad news becomes good news" for the markets. Although the economic environment at that point might still be more challenging than it is now, the end of the tightening cycle could then be in sight. This would all take place in an environment where growth is more difficult to find and rates are higher than they have been for many years. With this in mind, we believe investors would benefit from a diversified portfolio anchored around a selected number of high-conviction strategies:

- Quality value stocks that have healthy dividends: these may earn a premium price from investors amid higher interest rates.
- Quality growth stocks with strong balance sheets after a strong derating: these names could be attractive, as their growth profile helps them stand out amid poor global growth and an economic slowdown.
- Energy security and food security: given the geopolitical uncertainties that have made these areas more vulnerable, these are solid thematic investments that can help investors reposition portfolios.
- "Impactful innovation" stocks, including artificial intelligence, cybersecurity and climate mitigation/adaptation names: this category should be considered a critical pillar for portfolios.
- China equities: these could be increasingly attractive, though volatility is likely to continue. China's GDP growth of 4%-5% is notably higher than the world's other major economies; its GDP is also high compared with many emerging economies. In addition, China is less exposed to the negative effects of a strong US dollar. Moreover, China's central bank is now loosening – not tightening – its monetary policy.

Viewpoint

Fixed-income strategy: investing at an inflection point for growth and inflation

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Global CIO Fixed Income

Growing recession risks may help bring down inflation somewhat

At the start of the year, we expected that the key market risk for 2022 would be whether major central banks could rein in historically high inflation without leading to a sharper-than-expected global downturn. So far, core government yield curves have been flat, which indicates that although we may not be in a recession, the market thinks this may be the tail end of a very short economic cycle. Fixed-income investors will want to keep a watching brief on which direction the following factors take as the remainder of the year unfolds:

- **Growth:** clouds have begun to gather on the global growth outlook, given increasing headwinds from tightening financial conditions and the squeeze in households' real incomes. The geopolitical and supply-side implications of the invasion of Ukraine have intensified the downside risks.
- **Inflation:** as recession risks grow, we expect global inflationary pressures to ease up by the end of the year and into 2023. However, before inflation eases, it is likely to stay elevated in the near term given ongoing supply/demand imbalances and elevated commodity prices.
- **Monetary policy:** major central banks in developed markets are still inclined to maintain their hawkish policy stance in the face of historically high inflation data. The Fed is unlikely to change course until it sees clear evidence that inflation is coming down towards its target. Meanwhile, the European Central Bank is leaning towards bigger (and faster) rate hikes on the front end. We believe that, at least in the short term, the Fed will want to do what the markets expect – meaning the Fed funds rate will probably be near 2.75% by the end of 2022 (see **Exhibit 3**). However, we believe that the appetite for further tightening is likely to wane into 2023 as downside growth risks become more evident.

Fixed-income strategy

(continued)

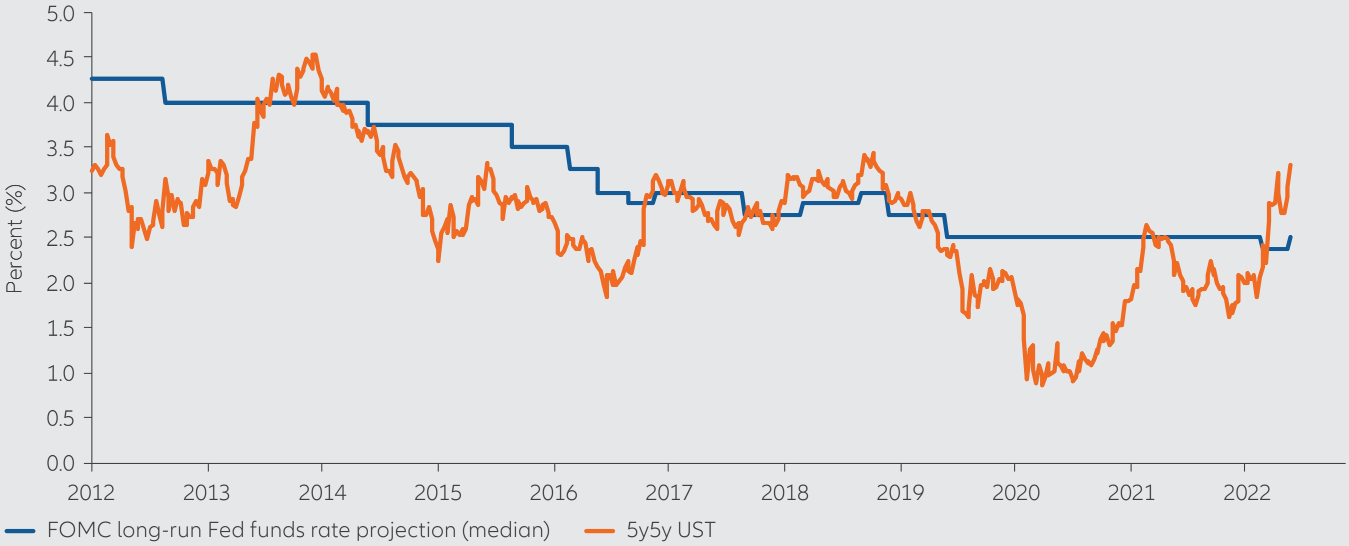
How to position fixed-income portfolios in this environment

Given all the uncertainty about which way the year will play out, we expect some near-term volatility in bond yields. However, we think we are at an inflection point for growth and inflation dynamics. Major central banks in developed nations may not yet be ready to pivot away from their hawkish policy stance, especially while current inflation remains at historic highs. But we think that as downside growth risks gather pace towards the end of this year and into the next, bond markets are likely to begin reassessing the extent of rate hikes in this cycle. Here are some strategies for fixed-income investors to consider:

- We may begin to see certain attractive longer-duration sovereign bonds in markets where rate hikes have been largely priced in, and where downside growth risks are set to become more apparent in the coming months. These markets include the US, Australia, New Zealand and Canada.
- Euro-area peripheral and semi-core bond markets don't seem as well-positioned. In euro-area sovereign-bond markets, deteriorating fiscal metrics and a tighter ECB monetary policy stance suggests a further widening of spreads in peripheral markets, especially Italy.
- Among emerging markets (EM), selectivity is key. Geopolitical and supply-side pressures are sustaining underlying inflation, particularly in food prices, which represent a larger share of EM consumers' inflation baskets. Among EM hard-currency bonds, high-yield spreads are wide. They may begin to come down as prices rises, which would make a compelling total return proposition for investors who already own these bonds.
- Among investment-grade bonds, corporate fundamentals are still reassuring, but downside growth risks support a defensive stance. Yet there may be opportunities for adding exposure to certain US high-yield names on any further spread widening, for the same reasons mentioned above. We also prefer US over euro spreads, and we favour entities with strong pricing power, such as global financials and US utilities.

Exhibit 3: in this economic cycle, a lot has already been priced into bond yields

Over the past decade, the US 5-year/5-year forward rate has tended to suggest a soft ceiling for 10-year yields. In mid-June 2022, the 5y5y rate sat around 3.30% – well above the Fed's median long-run "dot-plot" projections of 2.5%.



Source: Bloomberg, Allianz Global Investors. Data as at 15 June 2022.

Viewpoint

Multi-asset strategy: rapidly changing markets drive home the need for caution

Gregor MA Hirt
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Higher rates, higher costs and supply shocks add to companies' stress

If the US economy continues to slow, the Fed's decisive action to curb inflation seems likely to be the primary cause. But the broader global economy is also at a tenuous point, largely because of high inflation, supply-chain woes and uncertainty stemming from the invasion of Ukraine. Moreover, the world's second-largest economy – China – has struggled with slowing growth and Covid-19 outbreaks, lowering interest rates even as other major economies are beginning to raise them.

Against this backdrop of uncertainty, investors have finally started to question high prices for both stocks and many bonds, as well as lofty earnings expectations for many companies. More specifically, investors want to know if companies are being too optimistic about the solidity of their profit margins in an environment of rising input prices, whether these are wages or energy prices. This reassessment of the economic situation is also starting to spill over into the credit market – not to a dramatic degree, but it may further stress companies' margins by increasing refinancing costs.

Among our Multi Asset expert group, we have been cautious on equities for much of the year – particularly European and emerging-market equities, considering that the invasion of Ukraine may well have a more adverse impact on Europe. We have a slightly more constructive view of the UK and Japanese equity markets, although we have still reduced our exposure there. We have also been defensive with fixed-income markets in general.

All in all, we are entering a difficult period where still-worrying inflation rates will require most major central banks to reduce overall liquidity, even as higher yields, higher input prices and ongoing supply shocks affect companies' margins.

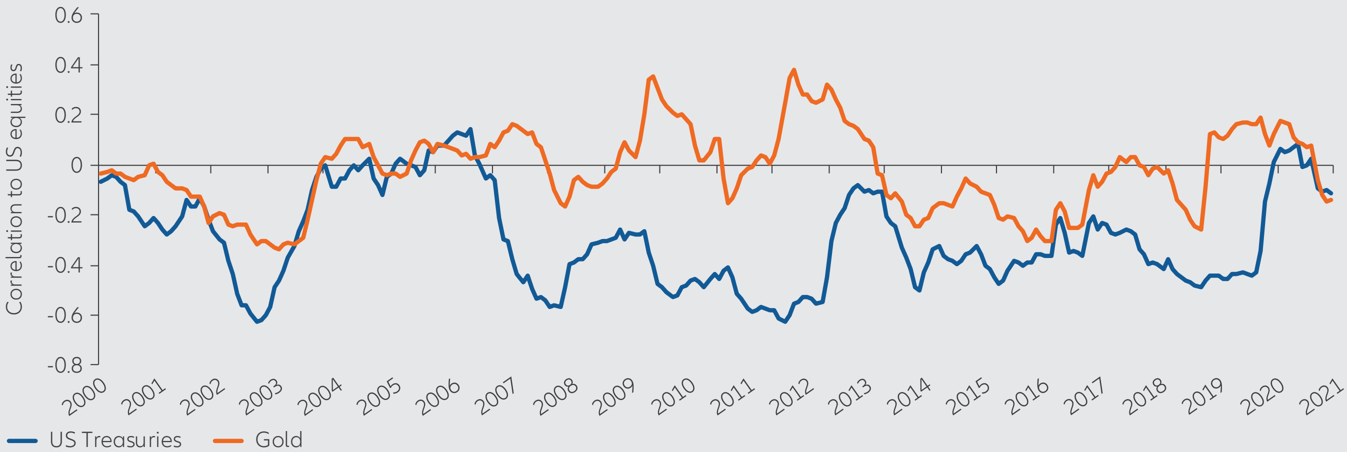
Despite the selloffs, long-term opportunities can be found

Amid all these challenges, valuations have started to come down from what were too-rich levels. This may create opportunities for investors to re-enter the market at more attractive price points. We believe it may be wise to keep some cash on the sidelines for undervalued securities and select strategies.

- Commodity investments may help guard against rising inflation. In addition, as **Exhibit 4** shows, gold may provide better diversification for equities than government bonds – at least for the time being. Commodity trading advisors are also benefiting from this environment, as they can short markets.
- The UK equity market has potential, thanks to its exposure to energy and healthcare, and its defensive bias.
- Alternative beta-type strategies, including long/short strategies, have experienced a renaissance this year.

Exhibit 4: with Treasuries now providing less diversification to US equities, gold is one potential substitute

US Treasuries have grown increasingly correlated to US equities, even as investors moved out of Treasuries amid concerns about rising inflation. As a result, Treasuries have become a less effective diversifier, particularly when compared with gold. In this context, commodities in general – and gold in particular – may currently provide better diversification.



Source: Bloomberg. Data as at June 2022. Chart uses monthly average of daily rolling correlation based on rolling 260-day window using daily returns of US equities (S&P 500 futures), US Treasuries (US 10yr Treasury futures), Gold (Gold futures).