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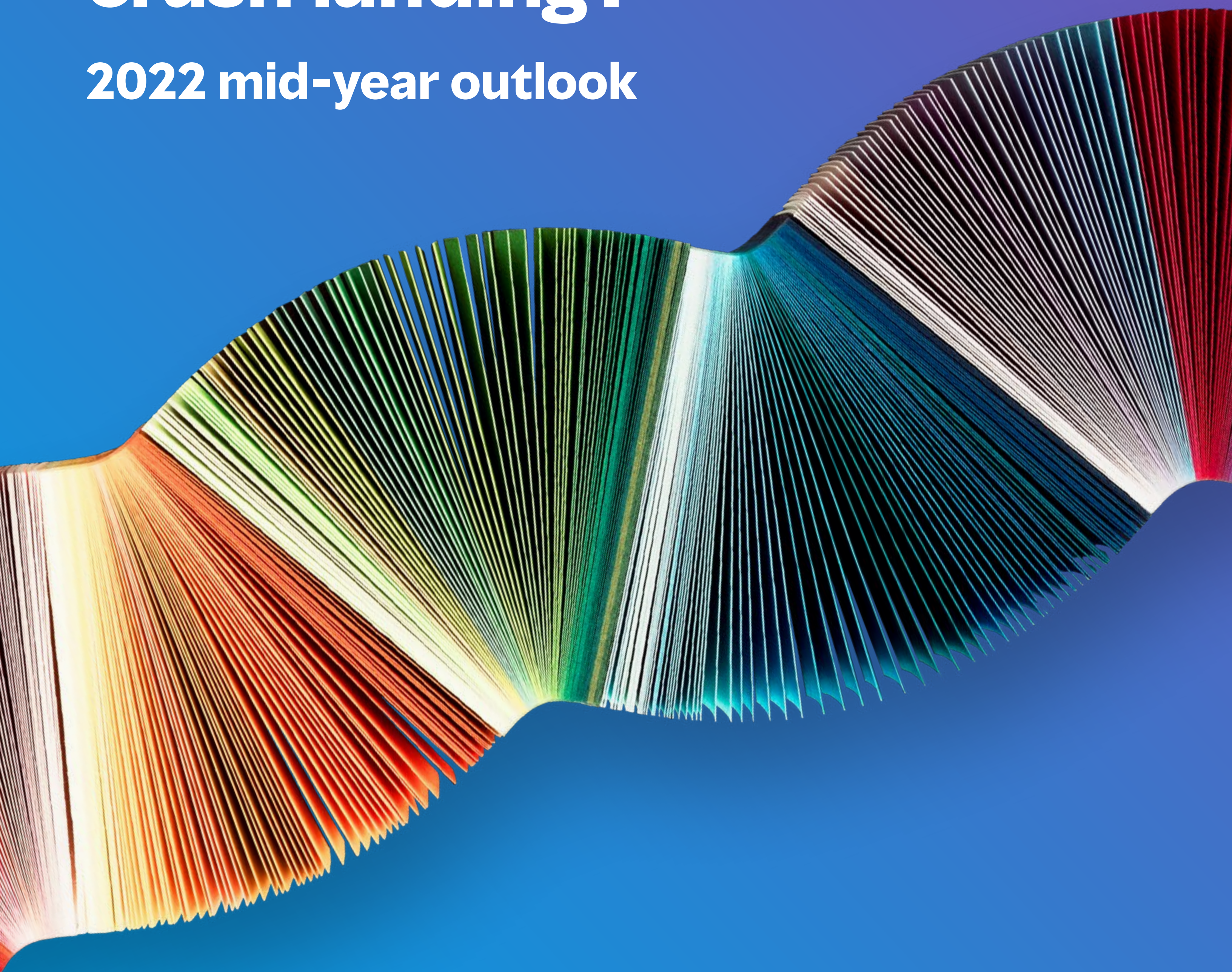
Can inflation be curbed without a crash landing?

2022 mid-year outlook



After a turbulent first half, markets debate a soft vs hard landing

Inflationary pressures that began bubbling during the Covid crisis have come to a head, and central banks are fighting it by engineering an economic slowdown. Risks remain high in some markets, but in others there are grounds for optimism and buying opportunities.

The global economy is facing significant cyclical pressures. After an unprecedented recession driven by the COVID-19 crisis, economies have recovered aggressively. However, that recovery has outpaced capacity and, combined with supply chain disruptions, high commodity prices and tight labor markets, has ignited inflation across both developed and emerging markets. Although some emerging Asian economies, such as China and India, are not witnessing the same price pressures as the rest of the world.

The Federal Reserve (Fed) and other central banks have begun tightening monetary policies to curb these inflationary pressures. A slowdown is now inevitable, it is necessary to ensure inflation – wage inflation, in particular – does not become entrenched.

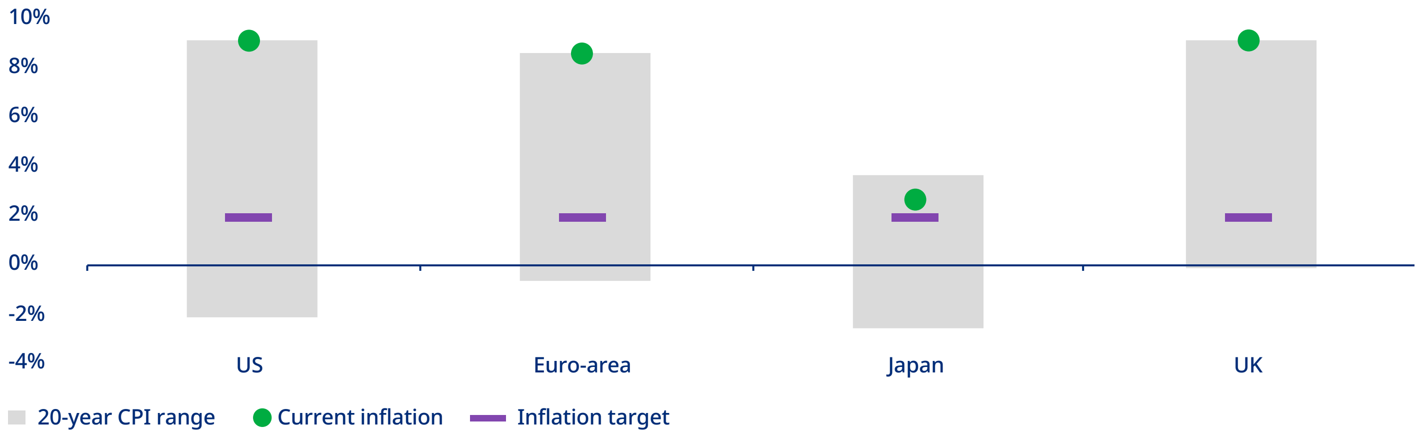
The Fed's response has been belated, but we believe inflation is likely to be brought back towards the 2% target over the medium term, consistent with sustainable growth in the US. Further, our base case is that this can be achieved without a deep recession as we believe the global economy is fundamentally resilient. We believe that the excess savings accumulated over the COVID crisis and healthy corporate balance sheets are likely to provide a valuable cushion in a period of tightening financial conditions and economic slowdown.

Although our base case is for inflation to be tamed without going through a period of deep recession, the risk of recession is elevated. The more upward inflation surprises we get, the more entrenched inflation becomes and the more likely the Fed (and other central banks) will need to slow economies down even more harshly to help achieve price stability in the medium term.

Regional variations

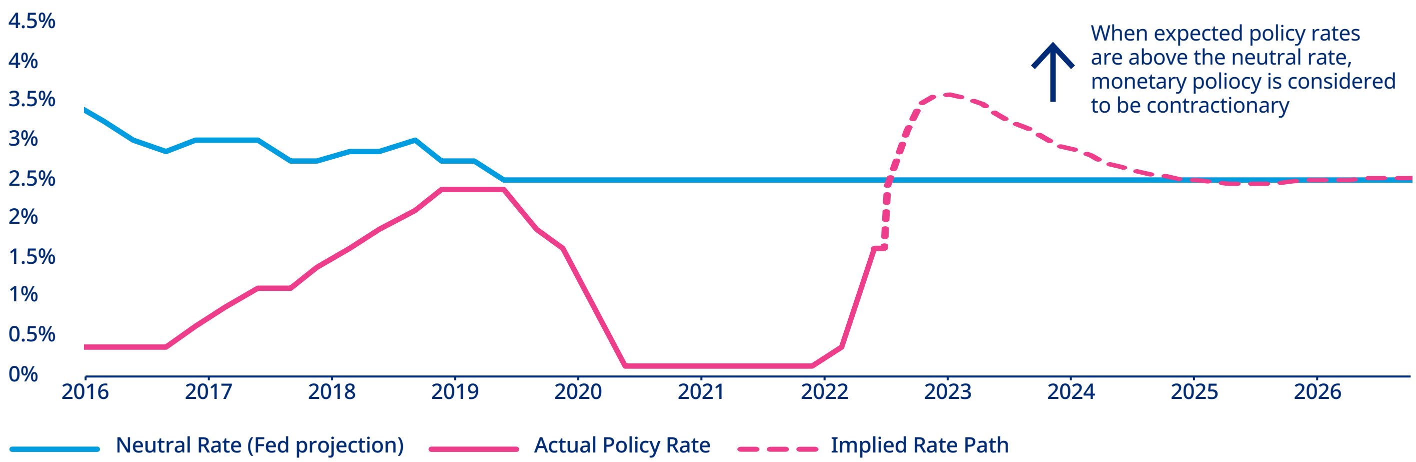
The factors driving the US economy are common to most developed markets, but there are significant variations in probable outcomes over the coming year.

Figure 1. Inflation remains at multi-decade highs and significantly above inflation targets in most regions



Source: Bloomberg, Mercer. Data as of June 30, 2022.

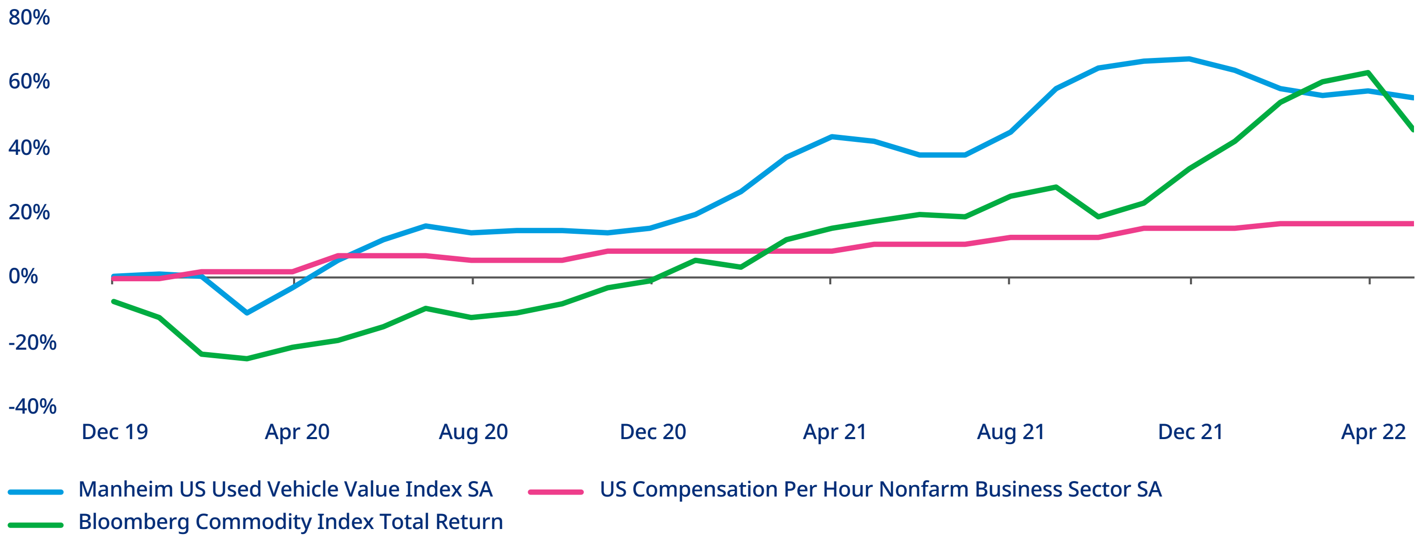
Figure 2. Overnight index swaps are pricing tighter monetary policy



Source: Bloomberg, Goldman Sachs, Mercer calculations. Data as of July 15, 2022.

The UK and the US are in a similar position, and the Bank of England (BOE) has been clear that it recognizes the risk of spiraling wage-price inflation and that it will act to restrain inflation. In the US, in particular, wage growth is increasing at a phenomenal rate, and it is likely that the unemployment rate will have to increase to slow the growth in wages.

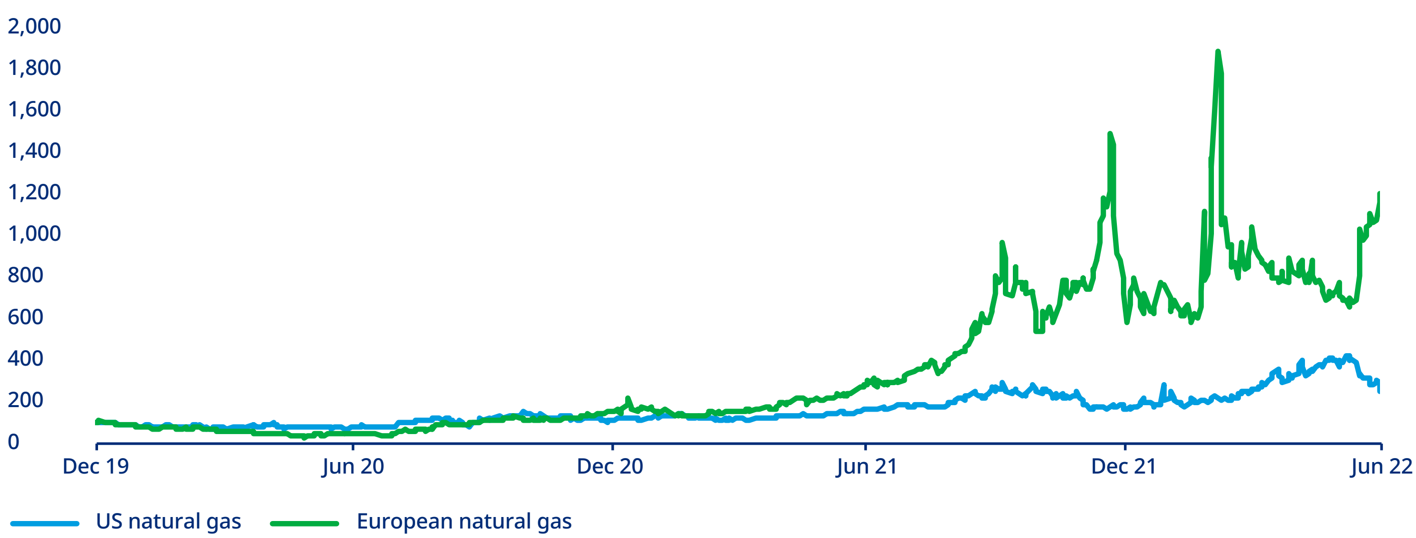
Figure 3. Inflation has transitioned



Source: Bloomberg, Mercer. Data as of June 30, 2022.

The Eurozone and the rest of continental Europe faces a more difficult balancing act. Economies in mainland Europe are more exposed to energy price shocks than the US and the UK due to their reliance on Russian energy. This exposure will make achieving a slowdown without recession more challenging.

Figure 4. US and European natural gas prices



Source: Bloomberg. Data as of June 30, 2022. Rebased to 100, December 31, 2019.

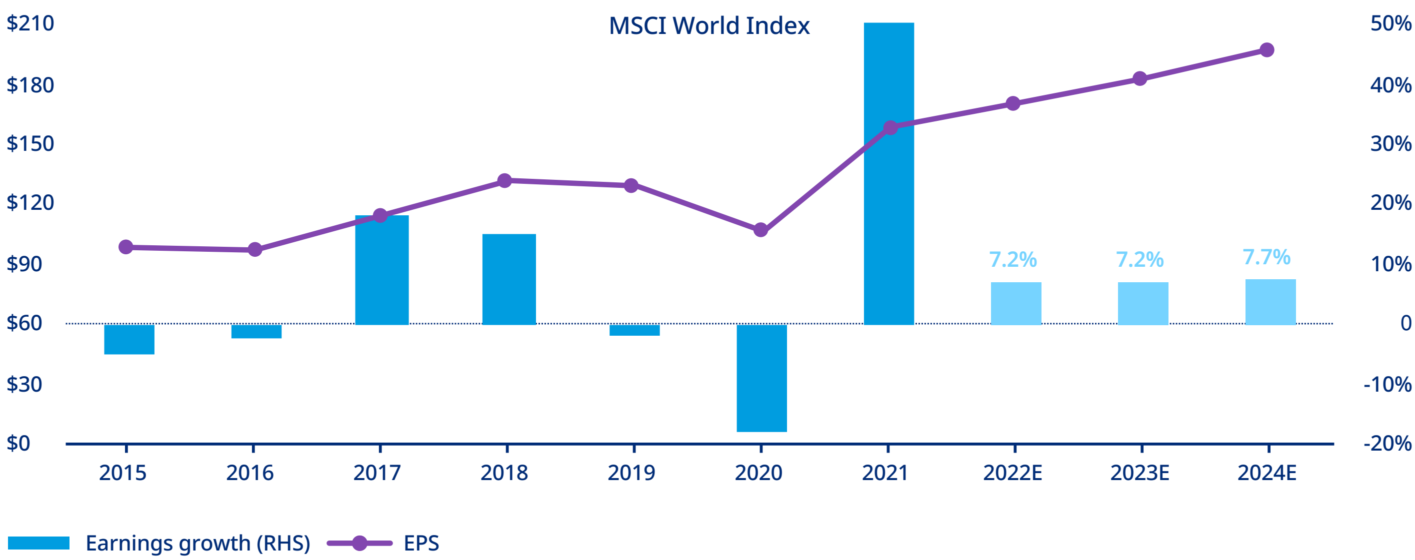
The picture in Asia-Pacific is even more varied. The Bank of Japan has not yet tightened monetary policy with its core inflation remaining relatively low.

China is the outlier among the world-leading economies. Following a slowing in its housing sector and covid-related lockdowns, China has gone through a heavy downturn. The lockdowns have however eased, and stimulus measures have been enacted, both fiscally and monetarily, with the government noting that it will strive to meet its growth targets for the year, despite the impact from covid year-to-date. This divergence between China and other developed economies is an interesting and potentially positive global dynamic in which China's stimulus phase may provide diversification to slowdowns elsewhere.

Equity and fixed income

Global equities have returned -20% year-to-date[1], and the S&P 500 has now seen its worst H1 total return performance in 60 years[2]. The decline in equities thus far this year has largely been driven by rising bond yields rather than any significant deterioration in equity fundamentals. Therefore, this has begun to make global equity valuations across all sub-sectors look more attractive. However, there are also downside risks; earnings forecasts remain optimistic which may require revisions if a slowdown takes effect and a quarter of investors see a global recession as the biggest tail risk[3]. Overall, although valuations are now considerably more attractive, the unfavorable macroeconomic backdrop and sentiment informs our decision to remain neutral on global equities.

Figure 5. Earnings-per-share growth forecasts



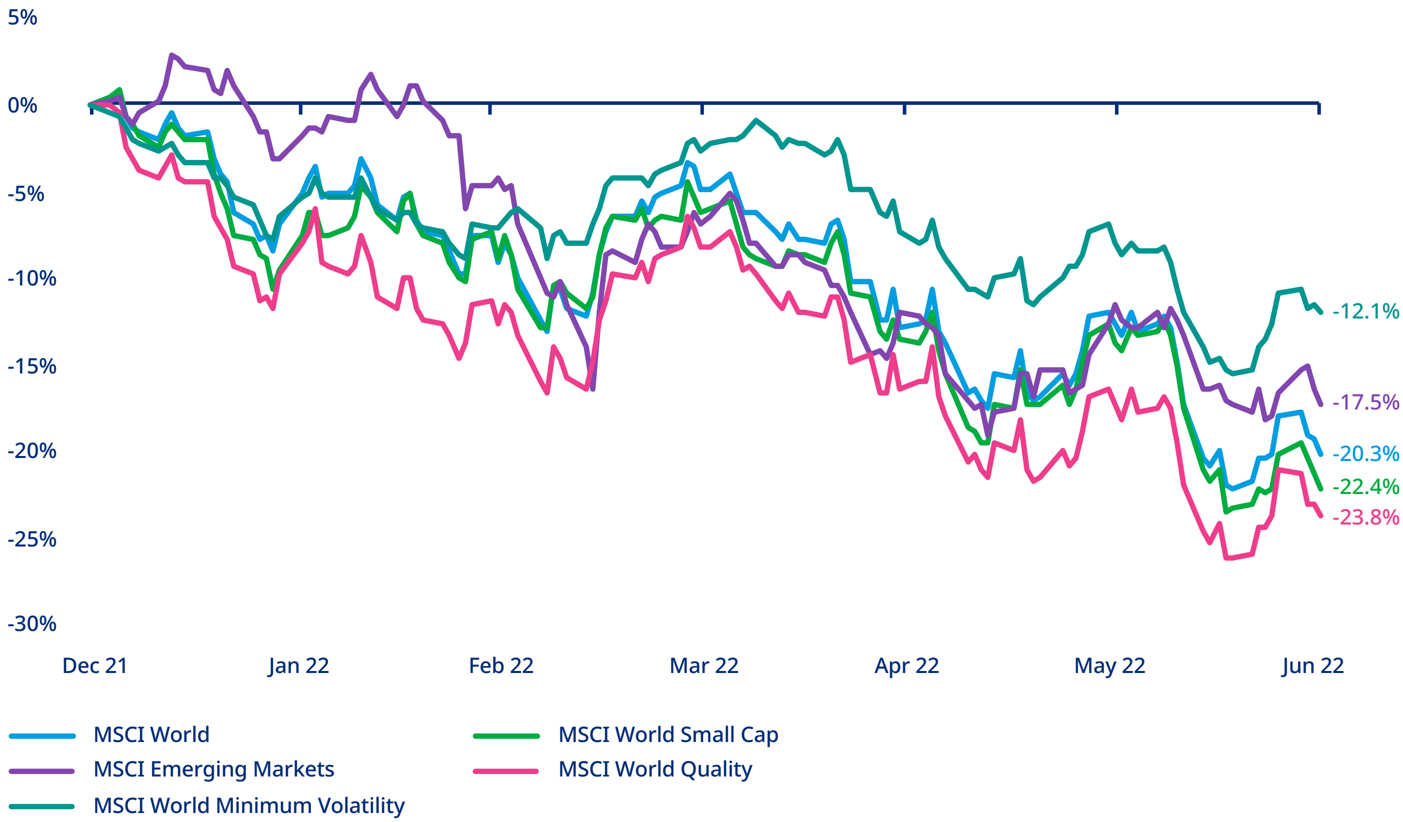
	2019	2020	2021	2022E	2023E	2024E
Global	-2%	-18%	50%	7%	7%	8%
Europe ex-UK	0%	-30%	66%	13%	6%	8%
Japan	-12%	-30%	69%	12%	5%	7%
UK	-6%	-41%	90%	19%	1%	2%
US	0%	-12%	47%	7%	9%	9%

Source: Bloomberg. Data as of July 14, 2022.

[1] Refinitiv. Data as of June 30, 2022. MSCI World TR Index.
[2] Deutsche Bank
[3] Bank of America Fund Manager Survey June 2022

Within that neutral global outlook, we have a slight preference for small caps where, alongside attractive valuations–a soft landing scenario would produce more upside than the other equity sub-sectors due to the cyclical nature of the asset class. The prospects for equities as a whole remain uncertain and growth and inflation data over the coming months will determine whether a shift to a higher conviction view is merited.

Figure 6. Equities in bear market leads to more attractive valuations



Source: Refinitiv. Data as of June 30, 2022.

Returns for bonds and credit were also negative in H1 2022 as markets reacted to accelerating monetary tightening and rising yields. US 10-year Treasury bonds recorded their worst H1 since 1788[4]. Credit spreads also widened for both investment and non-investment grade during H1.
In light of our base case expectations for a soft landing for the economy, we are increasingly finding credit markets to be more attractive, though again variations between debt subsectors are significant. We remain relatively more positive on investment grade credit but with high yield spreads widening and yields reaching 9%[5] we believe this could become an attractive opportunity in the next three to six months, once some uncertainty in the economic outlook subsides. Whilst the rise in sovereign bond yields has changed their relative attractiveness, we favor credit over sovereign bonds due to our outlook.

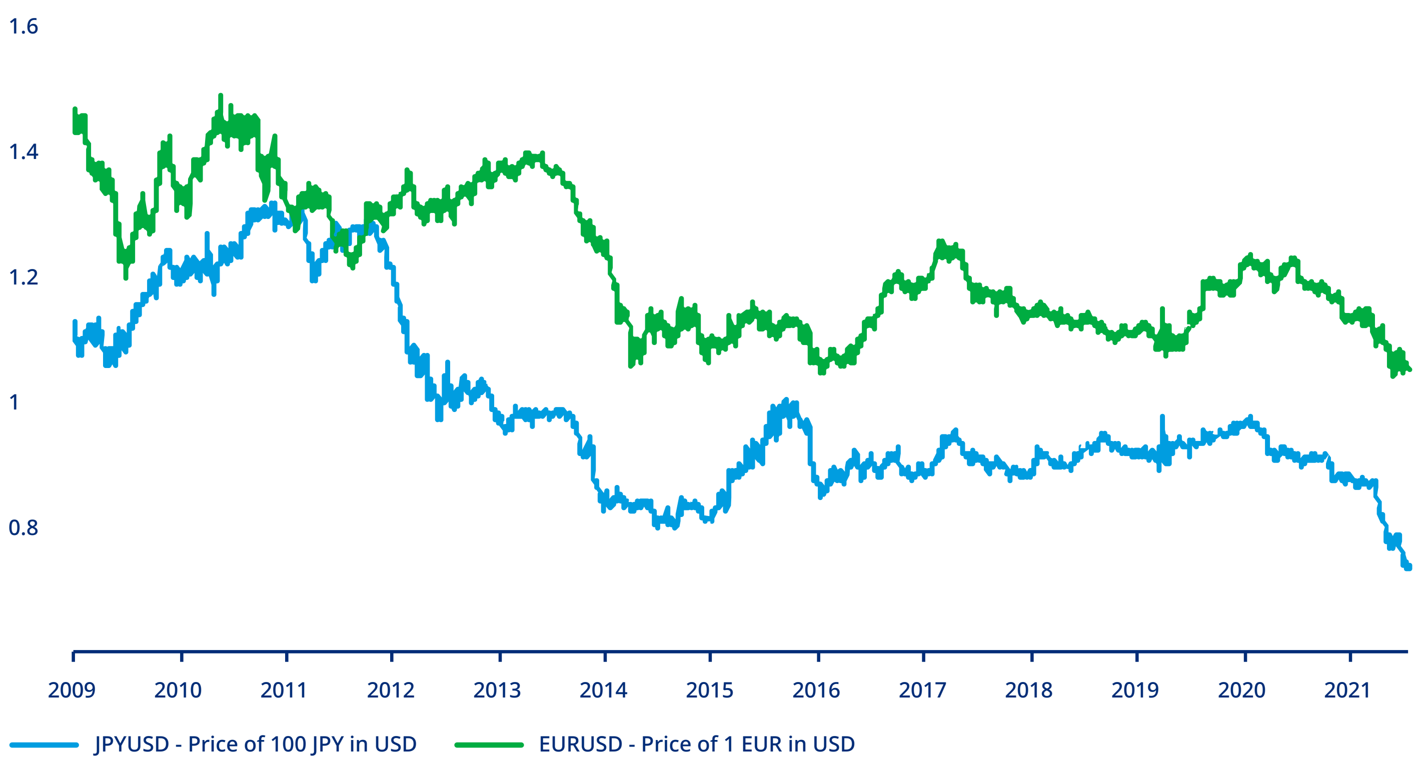
[4] Deutsche Bank
[5] Bloomberg. Data as of June 30, 2022.

Currencies

The euro has come under a lot of pressure lately, depreciating vs USD by c.8%. That was driven by the widening trade deficit in Europe, widening interest rate differential between Europe and the US and the rising cost of energy imports. In the event of a hard landing for Europe, the euro may come under even greater pressure and trade below parity with the US dollar.

We view the principal opportunity in currencies to be the yen. The Bank of Japan's (BOJ) looser monetary stance has helped drive the currency to its lowest levels against the US dollar in Purchasing Power Parity (PPP) since the 1970s. Whilst Japan's monetary policy is unlikely to change in the immediate future, the yen looks attractive on a valuation basis, and may provide some diversification should risk markets deteriorate.

Figure 7. US dollar appreciates as monetary policy divergences come to the forefront



Source: Refinitiv, Mercer. Data as of June 30, 2022.

Conclusion

Geopolitical turbulence, volatile markets, tightening financial conditions and sharply rising global inflation have defined the first half of 2022. Central banks' fight with inflation will slow economies down. The question is whether that leads to a soft landing or a hard one. We lean towards the former rather than the latter, although acknowledge that the range of outcomes is larger than normal given the unprecedented events in recent years.

In our central case of a soft landing, we believe certain growth fixed income segments offer value while we believe the outlook for equities is more balanced with a slight favor for small-caps. We are neutral on sovereign duration. In currencies, we see opportunities in Japanese yen as a hedge against possible recessionary outcomes.

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