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GLOBAL INVESTMENT COMMITTEE'S OUTLOOK: MORE "STAGFLATION-LITE", MODERATELY POSITIVE ON EQUITIES EX EUROPE, STILL NEGATIVE ON GLOBAL BONDS

Global economic recovery slightly below consensus, with inflation above consensus, but skirting global recession

Our mid-March meeting's "unenthusiastic" stance on global equities and negative stance on global bonds was a respectable decision, as was the overall macro theme "Stagflation Lite with GDP somewhat worse than consensus, but skirting recession." Globally, GDP consensus for CY22 is now, with the exception of the Eurozone (dubiously so, in our view), moderately below what it was in March. However, partly due to US inflation being even higher than our consensus-exceeding forecast, our bond yield forecasts, especially for US Treasuries, were far too low, and thus the USD appreciated much more than we expected. Our forecast that G-3 central banks would be more hawkish than consensus was accurate, but they, except the BOJ so far, have been even more so than we expected. Since our meeting's call for moderately higher commodity prices, grains are up slightly, but industrial metals are well below. Brent is below what we expected, noting that March's meeting coincided with Brent's near-peak levels on a rolling front-month basis, while the current front month, August, equals that on our meeting's base date. Our very cautious stance on geopolitics not getting better globally, and that multiple market-impacting events would occur, was quite predictive, but we did not forecast lockdowns in China and their associated stagflationary global supply chain woes.

Looking forward in obviously murky conditions, on 23 June, out of the six macro-economic scenarios presented, **our committee was fairly split between the continuation of this scenario and a more positive scenario of inflation falling steadily along consensus lines, but the plurality decided to proceed with the former. Thus, there is more upside risk for markets and economies than downside, in our view.** Given the continuation of this scenario, we expect corporate guidance in the upcoming earnings season to be even more 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 the Ukraine conflict to cause major economic dislocations, especially for Europe, **but based on this backdrop, our fixed income and equity teams delivered targets that imply improved performance for global equities in aggregate for the next three to six months (although quite negative for Europe), with moderate weakness for global bonds.** We expect commodity prices to rise mildly further, as the world-ex Europe avoids the high chance of recession currently priced into markets, even as we forecast that central banks will be slightly more hawkish than consensus.

Our new scenario predicts that globally, GDP will mildly underperform consensus, with the US up 2.1% on a Half on Half Seasonally Adjusted Annualised Rate (HoH SAAR, as used in all references below) in the 2H22 and 1.3% in the 1H23 (vs consensus of 2.3% and 1.4%, respectively). Personal consumption should grow only moderately, with increased production of autos fulfilling pent-up demand as one of the few major areas of growth, while private capex and government spending will likely be subdued. Meanwhile, net foreign trade will likely continue to subtract from GDP growth, as will housing construction.

Eurozone GDP will continue to be hurt the most by the Ukraine crisis and should grow only 0.3% in the 2H22 and 1.0% in the 1H23 (vs consensus of 1.0% and 1.9%, respectively). Meanwhile, **although a slow global economy will be a headwind, Japan's economy should benefit from re-opening,** growing 2.2% in the 2H22 and 1.0% in the 1H23 (vs consensus of 2.7% and 1.5%, respectively).

On China's economy, we continue to expect that it will be able to wade through its current troubles, although it should continue to be quite rocky at times. The recent lockdowns negatively affected both domestic and global growth, especially when considering supply chain disruptions, but the reverse of such should occur now, especially in the 3Q. Thereafter, however, there remain many problems. 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). It seems rather clear that property prices will be very challenged ahead, especially if empty apartments are increasingly sold on the secondary market. The government is aware of these various problems and is reducing regulatory pressure somewhat and trying to patch-up various crisis points, but it will likely maintain the course away from a property-driven nation towards a technology-driven one. In sum, we forecast its GDP to be disappointing, but not a disaster, growing 7.2% HoH SAAR in the 2H22 (due to the post-lockdown rebound) and 4.0% in the 1H23 (vs consensus of 7.8% and 4.5%, respectively).

For full year 2022 GDP growth, while the US should match consensus at 2.5%, the Eurozone, Japan and China, at 2.7%, 1.4% and 3.5% respectively, should moderately underperform consensus of 2.9%, 1.5% and 4.0%, respectively, and one should note that these numbers are boosted by low base effects (especially Europe), so they are weaker than they appear. One major risk factor is if labour strikes accelerate further globally, especially in Europe, from their present, already high levels. Suffering lower lifestyles for geopolitical reasons may be tolerated more than in the past, but some countries in which socialism is highly prevalent, especially in Europe, will face a populace that will force corporations to share the burden with higher salaries and, thus, lower their corporate profits. These strikes will be painful and if a solution cannot be quickly found, these countries will enter significant recessions that might metastasise.

Geopolitics will no longer be ignored

Whereas in the past the problems were fleeting, geopolitical risk should now remain something that markets will not ignore. Not only will the Ukraine conflict continue to be a major problem, North Korea, China and the Middle East need watching. On Ukraine, although fighting might lessen after July, Russia likely wants to annex a large part of eastern Ukraine, which will likely never be accepted; 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, although neither side seems willing to cross any red lines, while China's support of Russia has the potential to cause 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, as the Iranians seem very eager recently and 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 sized (although mostly neutral-cost) fiscal bill to be achieved via the "reconciliation" method. Social issues will also likely provoke more 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 this should make risk markets and business leaders wary.

Our detailed forecasts:

Scenario 2	Jun 17 2022	Sep 2022	Dec 2022	Mar 2023	Jun 2023
JP Uncollateral Call	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%
US FF Rate	1.75%	3.00%	4.00%	4.75%	5.25%
ECB Policy Rate	-0.50%	0.50%	1.25%	1.75%	2.00%
UK Policy Rate	1.25%	2.25%	3.00%	3.50%	3.25%
JP 10Y Bond	0.25%	0.25%	0.40%	0.40%	0.45%
US 10Y Bond	3.23%	3.40%	3.60%	3.75%	3.90%
Euro 10Y Bond	1.66%	1.90%	2.05%	2.20%	2.35%
UK 10Y Bond	2.50%	2.70%	2.85%	3.00%	3.15%
AUD 10Y Bond	4.13%	4.30%	4.45%	4.60%	4.75%
USD/JPY	135.00	136.00	138.00	140.00	142.00
EUR/USD	1.05	1.04	1.03	1.02	1.01
GBP/USD	1.22	1.22	1.21	1.20	1.19
AUD/USD	0.69	0.71	0.71	0.71	0.71
SPX	3675	3805	4012	4121	4107
Euro STOXX	384	355	360	365	370
FTSE	7016	7150	7220	7320	7400
TPX	1836	1950	1980	1950	1900
Nikkei 225	25963	27500	28000	27500	26800
Hang Seng	21075	21075	21075	21075	22129
ASX	6475	6700	6850	6920	7000
Oil Brent	113	124	127	130	130
Gold	1841	1900	1920	1920	1920
BBG Commod (DJ UBS)	127	134	137	139	139

Central banks: Moderately more hawkish than consensus

We expect the Fed to hike 125 bps in the 3Q, 100 in the 4Q, 75 in the 1Q and 50 in the 2Q, which is slightly more hawkish consensus, although if there is deviation to that forecast, it is for the Fed to cut a bit less. As for the ECB, we expect it to hike 100 bps in the 3Q, 75 in the 4Q and 50 in the 1Q. Meanwhile, the BOJ in the 2H is likely to tinker with hawkishness like shifting YCC to a five-year rate, while hinting at 2H23 hikes. If, contrary to our forecast, the yen weakens substantially further, the BOJ might tighten sooner. **In sum, while a bit hawkish, this forecast is basically priced into markets, which should provide major relief for equity and bond markets.** One should note that fixed mortgage rates in the US have soared, 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. In the meantime, anyone on a variable mortgage rate will suffer major cost increases that will likely lead to a decent amount of defaults. Also, overdue residential rent cases in the US are surging and many will likely leave their current apartments, leaving landlords and any securities based on housing (with a similar situation for commercial properties) vulnerable to shocks.

Moderately increasing G-3 bond yields, USD moderately stronger

For bonds globally, relatively weak economic growth should offset higher than expected inflation, but Fed QT and the absence of ECB purchases 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 economic transition. For US 10-year Treasuries, our target for end-September is 3.40%, while those for 10-year Bunds and 10-year JGBs are 1.90% and 0.25%, respectively, mildly rising at year-end to 3.60%, 2.05% and 0.40%. Regarding forex, we expect the USD to hit 136 vs the yen in September and 138 at year-end, while it should also mildly strengthen vs the euro to 1.04 and 1.03 for those periods. After that, the USD should continue to strengthen moderately through next June.

This all implies that the FTSE WGBI (index of global bonds) should produce in USD terms a -1.1% unannualised return from our base date of 17 June through September and -2.7% 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 -0.4% and –0.5% through those respective periods, with JGBs returning +0.1% and -1.3%, respectively, so offshore bonds should have a mixed performance relative to JGBs.

The Brent oil price should rise mildly further, in our view, given that Russian oil and gas will not be fully diverted to other buyers and that the world will avoid a recession while still experiencing quite high inflation. There also remains a large possibility that Russia will reduce its supplies due to infrastructure “accidents” requiring very long repair and maintenance time (due to sanctioned Western equipment needed). The problem related to the transit of Russian goods through Lithuania to Kaliningrad could also cause major ructions in energy supply, including electricity. Damages to natural gas pipelines through the Ukraine could also occur, and one has already been closed down by Ukraine. 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. Moderate production hikes by the Saudis could also help. In sum, we expect Brent to hit 124 in September and 127 at year-end.

After another month-on-month (MoM) surge in the upcoming June data, we expect that headline and core CPI measures for the next few quarters will decelerate on both a MoM and YoY basis, although not as much as consensus expects. For the US headline CPI, we expect 7.0% and 4.5% in December and June 2023, respectively, vs consensus of 6.5% and 3.8%. For the US core CPI, we expect 5.2% and 3.9% for these periods vs consensus of 4.8% and 3.5%. Housing rent is the major culprit, but food, gasoline, airfares and services should also continue significantly upward, while new and used car prices should decline more fully quite soon, as production resumes. These rates obviously remain well above the Fed’s target even assuming the PCE deflators are a bit lower than the CPI. Thus, the Fed cannot pause just based upon short-term improvements; it needs to see continual, structural improvements, which should require quite a bit of time. It 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 improve ahead, ex Europe

The MSCI World Index fell 15% (unannualised in USD terms) from our base date through our meeting date this week, vs our -0.3% forecast, so we were clearly should have been more “unenthusiastic” than we were. Partly due to this major decline, **our new scenario forecasts much better returns for global equities in aggregate for the two quarters ahead as hawkish central bank policy is nearly completely priced in, investor sentiment is already very low, and valuations have improved**. There clearly are some bumps ahead, especially as **we expect corporations globally to guide very cautiously during the 2Q earnings season** as input costs surge and they more fully experience demand curtailment due to higher prices. Geopolitical events that hurt market sentiment and proper economic functioning should also curtail equities’ gains globally. One other item 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 a moderately enthusiastic 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 3.1% through September and 8.0% through December (3.9% and 10.4% in yen terms). **We expect declines in Europe to dampen overall gains, but even more positive returns elsewhere** (our coverage is only for developed markets).

In the US, the SPX’s PER on its CY22 EPS estimate has fallen from above 20 to around 16, which is clearly much more attractive. Rising fixed income yields will continue to challenge valuations somewhat, but buybacks remain strong. Earnings guidance ahead will obviously be crucial, but our global scenario suggests that CY22 earnings estimates should not fall much, if at all, from present levels. In sum, this should lead to a relatively stable PER and mildly increasing equity returns in the 3Q, with the 4Q performing even better given the reduction of recession fears. 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 rise to 3,805 (4.0% total unannualised total return from our base date) at end-September and 4,012 at end-December (10.1% return), with yen-based returns of 4.8% and 12.6%, respectively.

European equities did not underperform the US since our March meeting, which seems far too positive given the region’s strong economic connection to Russia and given our expectation that the Ukraine crisis, and, thus, its many associated troubles, will not improve greatly. Indeed, we continue to 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. The main support for the market last quarter was that the market PER was not so overvalued, but we expect equities to de-rate and for CY22 earnings growth expectations to shift to negative YoY levels. A weaker euro in the next six months will hinder USD returns, as well. The Euro Stoxx PER, at 11.9 times CY22 EPS current estimates is below its historical average, but as mentioned above, earnings forecasts and investor sentiment, along with the economy, should be quite negative, even as the ECB has to hike to prevent inflation and indirectly, labour strikes. Thus, we expect the Euro Stoxx index to fall to 355 at end-September and FTSE to 7,150, which translates to a total return of -4.0% (unannualised from our base date) for MSCI Europe through then in USD terms. However, we expect improvement thereafter, with a slight rebound in MSCI Europe's return, at -2.8%, through December.

Japanese equities since our last meeting fell in USD terms exactly in line with the US, which was disappointing. Equities in yen terms have not performed too badly, but the yen has been quite weak, mostly due to higher US interest rates occurring while the BOJ rightly insisted that sustainable inflation in Japan was not likely yet, and thus it did not tighten its policies. Given the full re-opening of the economy (and gradual reopening of international tourism) in the 2Q, consumer optimism is rebounding and 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 improved and should do so greatly further after June. **Corporate earnings continue to rebound and the weaker yen should assist such further, especially after 3-6 month forex hedges roll off**. Meanwhile, Japan has low political risk and structural reform is continuing, especially in digitalisation and alternative energy. Japan's low exposure to Russia is fortunate, although it will continue to be affected to some extent by higher global commodity prices and lacklustre global economic growth. Meanwhile, China's rebound from lockdowns will be particularly beneficial to Japan. TOPIX's PER fell to 11.9 times its CY22 EPS consensus estimate, which is very low, especially as CY22 earnings estimates in aggregate should remain firm. Also, to support the market are share buybacks that are on a record-breaking pace, and the market's dividend yield, which at 2.5% remains attractive vs bonds. Thus, we do not expect any valuation de-rating despite troubling geopolitics. We forecast TOPIX at 1,950 at end-September and 1,980 at end-December **for total unannualised returns of 6.2% in USD terms (7.0% in yen terms) and 6.9% (9.2% in yen terms)**, respectively, from our base date through those periods. As for the Nikkei, it should hit 27,500 and 28,000, 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 penalised 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 a weakening property market. However, improvements 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, while this autumn's extension of President Xi's term should also provide a harmless backdrop. In sum, we expect relatively stable returns for Hong Kong over the next six months, and moderately good ones for Australia, leading to **the region's MSCI index in USD terms to rise (total unannualised return) 5.2% and 7.9%** through September and December, respectively.

Investment strategy concluding view

"Stagflation-lite" coupled with a severe geopolitical crisis was much worse for equities than we expected, but most of the bad news is priced in, so the prospect for global economies and equities in aggregate should improve. While global GDP will, in our view, moderately underperform consensus, it should skirt recession and, thus, positively surprise equity markets, which increasingly have priced in recessionary conditions. Central banks will likely be a bit more hawkish than consensus, but the vast majority of this trend is priced in and fears of even worse developments in this regard should dissipate. Warnings about corporate profits should be a headwind for global equity markets, although we are moderately bullish for the reasons stated above, excluding Europe, especially as PER levels are much more attractive now. Meanwhile we expect continued poor returns for global fixed income, so we continue our view that 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