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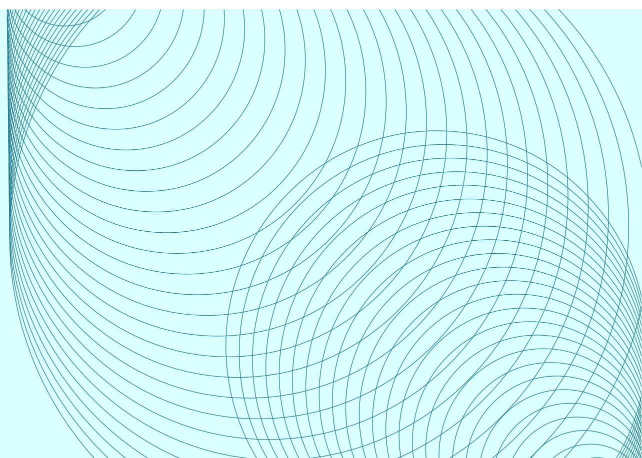

Global Investment Committee's Outlook

Rocky, but acceptable global returns

By John Vail, Chief Global Strategist
30 March, 2023

The world held up even better than we expected in the 1Q until....

Our December meeting's overall theme of "**Good, But Not Fully Smooth Sailing**" seems to have been reasonably predictive, as the global economy and markets were proceeding fairly well, with occasional troubles, but then were hit in March with even worse sailing conditions. Going back a bit, we called in mid-September for financial accidents to cause significant shocks to economies and markets, but those that did occur in the 4Q, especially in the Gilt market and the crypto industry, did make lasting impact on overall conditions. Our December meeting continued to predict some major credit problems in the US and EU, but lowered our concern level. Obviously, the March crisis in the US banking industry was more serious than we predicted in our prior meetings, and its future impacts on markets and economies is not well understood by investors yet.

Meanwhile, China recovered much as we expected in our December meeting, with some increasing signs of headwinds to consumption after the initial rebound already occurring, also in line with our predictions. The détente in foreign affairs has held fairly well, although tensions are very high, and much depends upon China's actions regarding its assistance to Russia and the development of the war in Ukraine. The Taiwan situation also remains crucially important.

Our December forecasts regarding the global economy seem to have been somewhat too low, but consistent with the fairly subdued growth conditions recently experienced, with the exception being that the Eurozone looks very likely to avoid the mild 1H recession that we predicted. For the most part, our 2023 GDP forecasts, which mirrored consensus at the time, are now lower than the current consensus with the exception of Japan, which disappointed consensus. Globally, our central bank expectations have been quite accurate so far, but the ECB raised 75 bps in the 1Q vs. our 50 bps estimate. Lastly, our positive stance on global equities and bonds was correct, but both gained less than we expected through 28 March. Our preference for equities over bonds was also correct, although not by a large margin. As for geopolitics, our view that such would be worrisome but not very impactful on markets was correct.

Looking forward in even more murky conditions, on 30 March, our committee decided, with a significant majority, on a macro-economic scenario in which financial accidents in the West (but not in Asian developed markets) continue to play a significant role in weakening the economy and restraining, but not ruining, investment optimism. We do not necessary expect any bank runs, although such are from impossible, but private lending, private equity, commercial real estate (including CMBS and bank lending to such) are highlighted areas for likely trouble. Markets are now more attuned to the risks in commercial real estate, but given that it is fairly opaque, with booked prices often lagging reality, and that it is one of largest asset classes in Western economies that is deeply entwined with both large and small banks, it is highly likely that the risks are underappreciated, especially as conditions in many of its subsectors are already very poor in the US and Europe. This is even more true now that bank regulators will be more diligent regarding the pricing of assets and the sectoral concentration of risks, while banks will very likely be turning much more cautious anyway and forced to charge higher rates to clients given that funding costs (except perhaps for the largest banks but possibly for them too as investors continue to shift away from low-rate accounts) are rising.

Given this as a backdrop, our scenario predicts that globally, GDP will moderately underperform consensus in the next two quarters. Beyond that, such should rebound approximately to consensus in the US in the subsequent two quarters but continued lagging consensus for the rest of the G-4. Thus, we forecast: **US** GDP up 0.3% on a Half on Half Seasonally Adjusted Annualised Rate (HoH SAAR, as used in all references below) in the 2Q23-3Q23 and 0.4% in the 4Q23-1Q24 vs consensus of 0.8% and 0.3%, respectively; **Eurozone** GDP at 0.0% and 0.1%, respectively vs. 0.6% and 0.9%; **Japan** at 0.4% and 0.0%, vs. 0.9% and 0.7%; and **China** at 4.8% and 2.8% vs. 6.5% and 4.9%. For full-year 2023 GDP growth, the US, the Eurozone, Japan and China, at 1.2%, 0.4%, 0.5% and 4.7% should lag consensus of 1.3%, 0.7%, 0.8% and 5.7%. Clearly, consensus is quite subdued for the global economy, with quite a few economists predicting recessions, and our forecasts are even moderately more negative, **but in no case do we expect a recession. However, one major risk factor is if labour strikes accelerate further globally, especially from their already quite worrisome levels in Europe, but also quite possibly in the US and in various important emerging markets like Peru.** The UK has experienced major strikes, and many have been settled with very large wage gains, so the second-round inflation effects are bound to be large for a year or two and may even cycle further after that. France has a different set of labour maladies, but strikes and wages seem certain to on a rising trend ahead. German strikes, especially in the transport area, are very troublesome, after being much quieter during the winter of war and energy-supply concerns. Indeed, countries in which socialism or major union power are prevalent will face a populace that will force corporations to share the burden with higher salaries, coupled with various negative government mandates that will lower their corporate profits. Economic growth could be obviously hurt by strikes, as well. Thus, if strikes occur in a deeply disturbing way, a global recession is quite likely.

Integrated with all of this, we expect central banks, excluding the BOJ, to moderately raise rates in the 2Q until financial accidents accelerate, pause in the 3Q while noting that second-round inflation effects remain substantial, but then start cutting in the 4Q and 1Q as economic growth, commodity prices and labour strikes falter (we expect declining commodity prices to allow consumer prices to fall more broadly, and, thus, labour will likely become less adversary by year-end).

Given this scenario, while corporate results in the upcoming 1Q earnings season might not disappoint too much, guidance is likely to be very cautious, with global demand decelerating while margins are being squeezed by higher labour and other input costs. Supply chain disruptions, fortunately, should be less of a burden to profitability. Investor sentiment, meanwhile, has shown to be remarkably resilient in recent days, with the confidence that all of the troubles will be eventually overcome. We expect that at least for the US and Japan, this should continue in the next two quarters, but will likely falter elsewhere, while obviously encountering occasional potholes. In the subsequent two quarters of 4Q23 and 1Q24, we expect strong rebounds in equity performance as central banks cut rates and economies do not fall into recession.

Geopolitics should not be ignored

Whereas in the past, 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, but North Korea, China/Taiwan and the Middle East require close monitoring. On Ukraine, although fighting will likely intensify in the coming months, we continue to see a frozen conflict ahead. It is quite possible that that grey-zone warfare with Ukrainian forces and with the rest of the world, including hacking, will disrupt markets, economies (especially as Ukraine and Russia are such large commodity producers that affect supply chains and inflation) and investor confidence. Meanwhile, relations between the West and China remain very tense, although neither side seems willing to cross any red lines, but China's support of Russia and North Korea 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 as an Iran deal now looks impossible, while the new government in Israel is the most aggressive ever.

As for US political risk, the country remains mired in conflict and we expect continued turbulence. Social issues will also likely provoke unrest and the outlook points to complete political stalemate. House Republicans will continue to investigate Democrats, including President Biden, which will likely prove unsettling. The net result of all of this should make risk markets and business leaders somewhat wary, although assuming the debt-limit bills pass without too much trouble, as we expect, urgent government action does not seem needed at this time and markets will likely see only minor economic impact from the turbulence.

Our detailed forecasts:

Scenario 2	Mar 24 2023	Jun 2023	Sep 2023	Dec 2023	Mar2024
JP Uncollateral Call	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%
US FF Rate	5.00%	5.25%	5.25%	4.75%	4.25%
ECB Policy Rate	3.00%	3.50%	3.50%	3.00%	2.50%
UK Policy Rate	4.00%	4.50%	4.50%	4.00%	3.50%
JP 10Y Bond	0.32%	0.35%	0.35%	0.35%	0.50%
US 10Y Bond	3.38%	3.40%	3.30%	3.20%	3.20%
Euro 10Y Bond	2.12%	2.30%	2.20%	2.10%	2.10%
UK 10Y Bond	3.28%	3.40%	3.30%	3.20%	3.20%
AUD 10Y Bond	3.22%	3.30%	3.20%	3.10%	3.10%
USD/JPY	130.7	130.0	129.0	127.0	127.0
EUR/USD	1.08	1.10	1.11	1.12	1.12
GBP/USD	1.22	1.23	1.24	1.25	1.25
AUD/USD	0.66	0.68	0.69	0.70	0.70
SPX	3971	4210	3969	4172	4319
Euro STOXX	442	395	395	425	440
FTSE	7472	6900	6900	7200	7350
TPX	1955	1930	2000	2060	2110
Nikkei 225	28283	27000	28000	28800	29500
Hang Seng	19916	18920	17924	19916	21908
ASX	6955	6300	6300	6400	6500
Oil Brent	75	68	66	68	70
Gold	2002	1850	1800	1800	1820
BBG Commod (DJ UBS)	103	90	85	85	90

Central banks: Fed and ECB peak in 2Q and start cuts in 4Q

Our new view on central banks not too different than consensus. We expect the Fed to hike 25 bps in the 2Q, and then pause until cutting 50 in the 4Q and in the 1Q of 2024. As for the ECB, we expect it to hike 50 bps in the 2Q, and then follow the Fed. The BOJ will likely increase the YCC band to 75 bps in 3Q, and maintain it there, without hiking policy rates. Furthermore, the Fed and ECB will proceed with QT and also, along with the BOJ, reduce their balance sheets by winding down special pandemic-related lending programs.

US and European bond yields rather stable ahead, while USD weakens moderately further

For bonds globally, weak economic growth, financial sector accidents and a continuing decline in inflation should help, although the final ECB and Fed hikes and continuing QT certainly will prove to be headwinds. Due to the financial scares, yields have already dropped substantially, and we see only moderate scope for continuation of such. Thus, for US and German 10-year bonds, we expect rates to be relatively flat through September, but to decline 10 bps in the 4Q and level off in the 1Q, whereas for Japan we expect stability until rising to 0.5% in the 1Q. Regarding forex, we expect the USD to decline moderately and gradually ahead. Notably, both the Gilt market crisis and the fear of reigniting inflation should keep the pressure on governments to avoid further fiscal stimulus, which should assuage bond investors.

One should remember that fixed mortgage rates, though down from their highs, have soared globally, which cause a major headwind to residential property market prices, which in turn should cause negative wealth effects and also credit problems. Also, in many countries, especially the UK, anyone with a variable mortgage rate will suffer major cost increases that will likely lead to a significant number of defaults. Also, overdue residential rent cases in the US are surging and many tenants will likely exit their apartments, leaving landlords and any securities based on housing (with a similar situation for commercial properties) vulnerable to shocks.

We forecast that the FTSE WGBI (index of global bonds) should produce in USD terms a 0.5% unannualised total return from our base date of 24 March through June, 2.6% at June-end and 5.0% by December. Thus, we are reasonably positive on bonds. For yen-based investors, however, this index in yen terms should return only -0.1%, 1.3% and 2.0% through those respective periods, with JGBs returning -0.2%, -0.2% and -0.1%, respectively, so offshore bonds should be preferred to JGBs despite mild yen strength.

The Brent oil price will likely be quite volatile, but decline, in our view, to USD 68 in June and December, due to slower than consensus economic growth. Of course, the Russian and Iran questions loom large, both geopolitically and as regards global oil supply, but we think that supply will adjust to any troublesome conditions in relatively short order.

Greatly due to the high base effect caused by the peak of commodity prices in 2022, coupled with deceleration in other prices, particularly the oddly calculated medical cost component, we expect the headline and core CPI readings to undershoot consensus estimates ahead, with the former at 2.0% and 2.1% in September 2023 and March 2024, respectively, and the latter at 2.9% and 2.2%. As for further details, housing rent will likely, due to the lagged effect of repricing of new contracts, continue to march upward, though to a lesser degree, but food, gasoline, airfares, new and used cars, apparel, home furnishings and many services prices should soften soon due to lower demand. Eurozone and Japanese CPIs should decelerate greatly ahead too, although the Eurozone will take longer to approach the ECB's target, especially if second round effects and labour strikes are more pervasive than expected.

After a troubled 2Q and 3Q, global equities should improve by the end of 2023

Obviously, our scenario entails a very bumpy ride for global equities, but with recovery to decent returns by year-end due to lower policy and bond yields, coupled with the continued rebound in China's economy. However, we emphasise shorter term perspectives (3-6 month returns) in our recommendations, **so we shift to a neutral view on global equities for the two quarters ahead.** Aggregating our national forecasts from our base date, we forecast that the MSCI World Total Return Index in USD terms will be 3.6% through June, -0.1% through September and +5.9% through December (3.1%, -1.4% and 2.9% in yen terms).

In the US, the SPX's PER on its CY23 consensus EPS estimate is quite high at 18.1 and earnings guidance ahead will likely be disappointing, but earnings growth will likely remain positively viewed, buybacks remain strong and the prospect of a dovish Fed should encourage investors despite some serious financial accidents. In sum, we expect the SPX to rise to 4,210 (6.5% total unannualised total return from our base date) at end-June, decline to 3969 in September (0.9% return), but then rebound to 4,172 at end-December (6.4% return), with yen-based returns of 5.9%, -0.5% and 3.4%, respectively. We expect **the US to outperform in the 2Q-3Q, but only barely so by end-December.**

European equities surged in the 4Q and 1Q, especially in USD terms, so the Euro Stoxx PER, improved to 13.0 times CY23 EPS consensus estimates, which is near its historical average. A key factor (along with, of course, the Russia-Ukraine situation) will be how pervasive labour strikes (and the resulting wage increases) are. We are a bit pessimistic on that front, given the confrontational socialist backdrop there. Meanwhile, there could be some problems associated with the merger of Credit Suisse and as mentioned before, Europe's commercial and residential property sectors will likely cause some banking troubles. Thus, we expect the Euro Stoxx index to fall to 395 at end-June and FTSE to 6,900, which translates to a total return of -7.2% (unannualised from our base date) for MSCI Europe through then in USD terms. Thereafter, we expect -5.4%, through September and +2.5% through December, which **argues for an underweight of the region after two quarters of preferring it.**

Japanese equities have performed quite well in USD terms in recent quarters. Corporate profit margins, though ticking down in the 4Q, remain very high and given the full re-opening of the economy (including inbound tourism), consumer optimism is rebounding. High inflation, which has worried consumers, looks set to decline ahead, especially with the Yen's recent rebound. The auto sector, which is a major portion of the stock market and economy, is finally fully recovering, but the global tech sector downdraft is hampering Japan's electronics sector. China's economic rebound is also helping Japan. 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, and it has secured its natural gas supplies from Sakhalin for the intermediate term. Meanwhile, the country will benefit greatly from lower commodity prices. TOPIX's PER is now 13.0 times its CY23 consensus EPS, which is attractive. Also supporting the market are share buybacks, which are very strong, and the market's dividend yield, which at 2.4% remains extremely attractive vs. bonds. However, global troubles will present headwinds, so we forecast TOPIX to decline slightly to 1,930 at end-June, but rebound to 2,000 at end- September and 2,060 in December for total unannualised returns of 0.0% in USD terms (-0.6% in yen terms), 5.0% (3.7% in yen terms) and 10.5% (7.4% in yen terms), respectively, from our base date through those periods. As for the Nikkei, it should hit 27,000, 28,000 and 28,800, respectively. **Thus, returns are meagre for the 2Q, but very attractive thereafter for both domestic and global investors.**

Developed Pacific-ex Japan MSCI: Australia should be hurt by declining commodity prices and lower global growth. Meanwhile, the domestic downturn in property prices is a headwind for many consumers due to the wealth effect, and for banks and construction firms too. Improved demand from China and more tourists from there and elsewhere are tailwinds, however. Hong Kong's stock market, which is dominated by PRC firms, rebounded sharply in the 4Q when China pivoted, but has softened since then. Hong Kong is certainly benefitting from a revival in tourism and the rebounding local property market certainly helps too, as will dovish central banks after the 3Q. Hong Kong's major

banks have some exposure to troubles in Europe, however, and the negative global market trend is bound to weigh on local stocks too. Thus, we expect the region's MSCI index returns in USD terms (total unannualised) at -5.3% through June, -5.0% through September and +1.6% through December. Thus, **developed Asia is not our top choice in the quarters ahead.**

Investment strategy concluding view

We expect fairly rough sailing for the global economy, financial system and markets in the next two quarters, but we do not expect disasters and there should be major relief for stocks later in 2023 as central banks begin to ease policy. Regionally, we prefer the US market for the next two quarters, but Japan's on a 9–12-month view. Overall, this leads to an overall neutral view for equities during the next two quarters, but quite a positive view thereafter. As for bonds, we are reasonably optimistic globally, excluding Japan, over the each of the next four quarters.

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