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Q3 outlook: Central bankers strike back

The more policymakers worry about inflation, the less investors need to. We're willing to buy into further market weakness – and have done so in the past weeks. But we're also likely to dial down our stance should the prospects of a recession grow.

Emiel van den Heiligenberg
Head of Asset Allocation

The first six months of 2022 were particularly challenging for investors, as central banks became increasingly determined to rein in inflation – sparking weakness across almost all asset classes. We believe the next six months will also prove tricky, while providing some tactical opportunities.

Macroeconomic data and news are flowing uncomfortably in the direction of both persistently elevated inflation and lower economic growth. The war in Ukraine continues to pile pressure on already-squeezed commodity markets.

Even though the outlook remains shrouded in uncertainty, we have a high conviction that central banks will act in the face of rampant inflation. This leads us to expect an aggressive set of rate hikes through the remainder of the year, even though higher prices are already starting to put the stoppers on economic growth as consumer confidence sinks.

A new narrative?

We also anticipate a US recession in the second half of 2023. But in the near term, we still see enough momentum in the economy, backed by a high level of savings, to stave off an immediate slump. Setbacks in markets are not uncommon around the start of a rate-hiking cycle, which on this occasion has also coincided with negative idiosyncratic events – not least, Russia's invasion of Ukraine.

The declines have resulted in tumbling valuations and triggered a sharp drop in investor sentiment. This means a fair amount of bad news has already been priced into markets, in our view. (See the section below by James and Lars for more on this theme.)

Indeed, we believe the market narrative might be about to turn, albeit temporarily, as investors see peak inflation and may start to believe a soft – or 'softish'– landing is more likely than previously thought. Other supportive factors include a slide in oil prices; a decline in food and semiconductors price inflation; and China's post-pandemic re-opening, which is likely to alleviate supply-side bottlenecks.

Our research suggests that the direction of inflation matters a lot for equity returns. An environment of high but falling inflation historically coincided with high real equity returns. By contrast, high and rising inflation, such as the recent market regime, coincided with the lowest historical real returns of all.

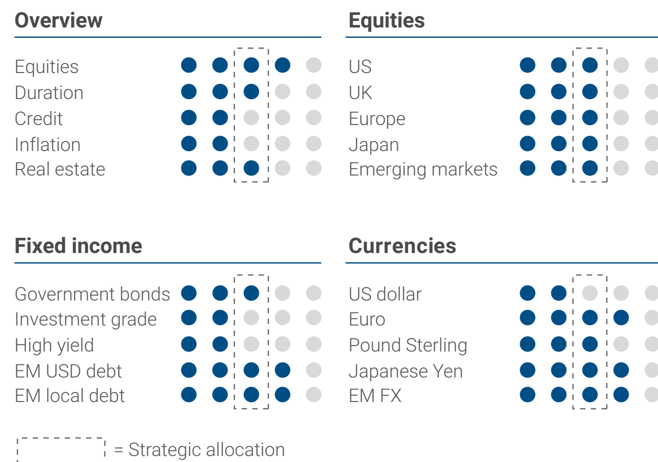
Comforting anxiety

Somewhat paradoxically, the tough action by central bankers also gives us cause for some optimism. Policymakers have blinked in the face of high inflation, so investors should no longer be in any doubt about their priorities.

While we are unlikely to have seen the last of the market volatility, we believe the more our monetary guardians worry about inflation, the less investors need to. The alternative of allowing inflation to run free would be considerably worse, in our view. (See Hetal and Simon's piece for more on how European policymakers are rising to this challenge.)

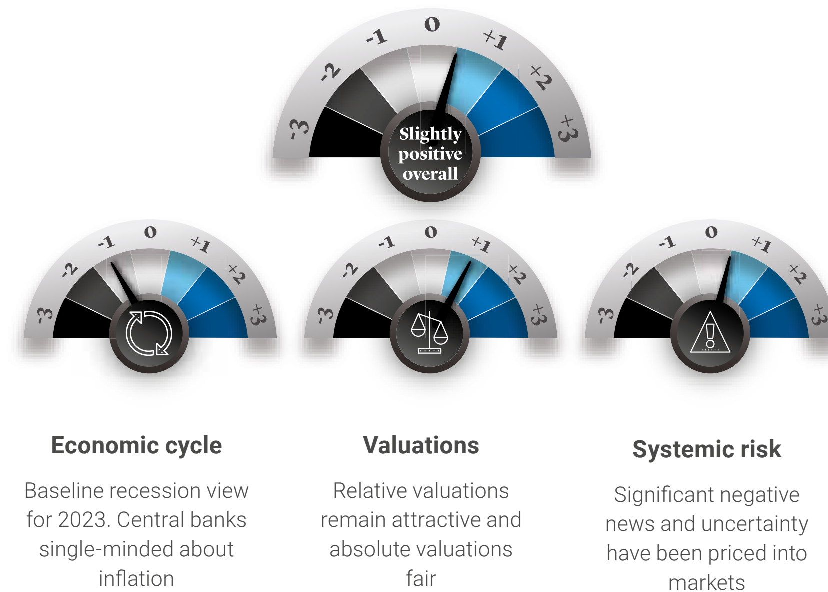
Against this backdrop, we feel comfortable in staying positive on equities, clearly an uncomfortable position in recent months, and in starting to decrease our underweight in corporate bonds. However, the scope for significant gains looks limited until there's more proof of inflation cooling and recession risks subsiding.

So we see our positioning in equities as more tactical – willing to buy into further market weakness, as we have recently done on the margin – but also likely to dial down our stance should the prospects of a recession grow. We expect such signs to emerge around the turn of the year.



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 24 June 2022. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point. **The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Summary of LGIM's asset allocation core view



Source: LGIM, as at 28 June 2022. **Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon.**

Economic cycle

- Late cycle squeezed by Ukraine conflict and China's COVID struggle
- Central banks on a mission to beat inflation with tighter financial conditions
- Recession has become the baseline view for 2023

Valuations

- Relative valuations of equities remain attractive as earnings yield increase
- Absolute valuations fair or cheap relative to long-term averages
- Credit spreads have moved towards non-recessionary wides

Systemic risk

- Ukraine war likely moving towards a frozen conflict
- Common goal of Western nations tightens resolve and eases prior tensions
- Recession risks, uncertainty and negative sentiment already priced in

James Carrick
Global Economist

Lars Kreckel
Global Equity Strategist

Is the US economy heading for a hard landing?

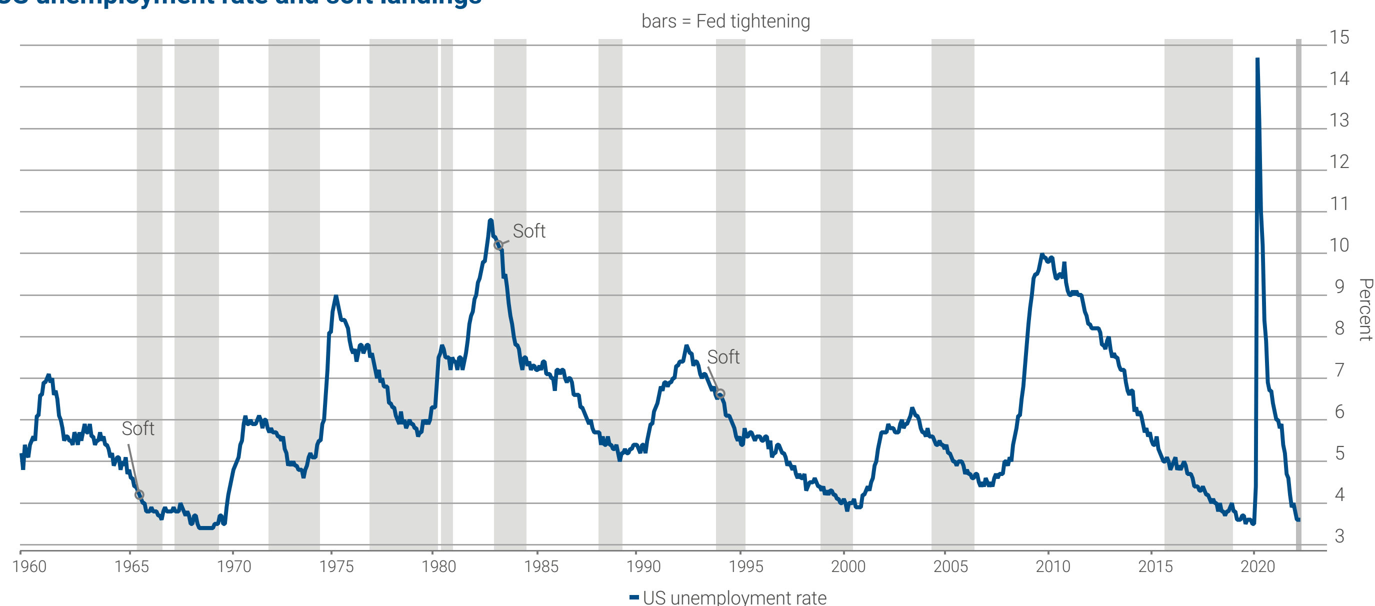
Jerome Powell previously argued a 'soft landing' could be achieved for the US economy, as the Federal Reserve (Fed) hits the monetary brakes to tackle rampant inflation. Was the Fed chair correct – and what might this mean for US equities?

In making his argument, Powell cited an interesting presentation by former Vice Chair Alan Blinder, which examines all hiking cycles since the 1960s. By contrast, former Treasury Secretary Larry Summers argues the economy is too overheated to deliver a soft landing.

We concur with Summers. Our research suggests that two thirds of hiking cycles over this period led to recessions – and that soft landings only occurred when the central bank raised interest rates more pre-emptively than it has done of late.

While near-term US growth looks assured, thanks to pent-up demand and continued easing of credit conditions, we expect aggressive tightening by the Fed ultimately to trigger a recession as we head into the second half of 2023.

US unemployment rate and soft landings



Source: Macrobond, as at 28 June

This wasn't the case in the mid-1960s, though, when core inflation was low and stable. Inflation was also on a declining trend in the mid-1980s and mid-1990s soft landings, while unemployment was still high. By contrast, unemployment is very low today while underlying inflation and wages have soared.

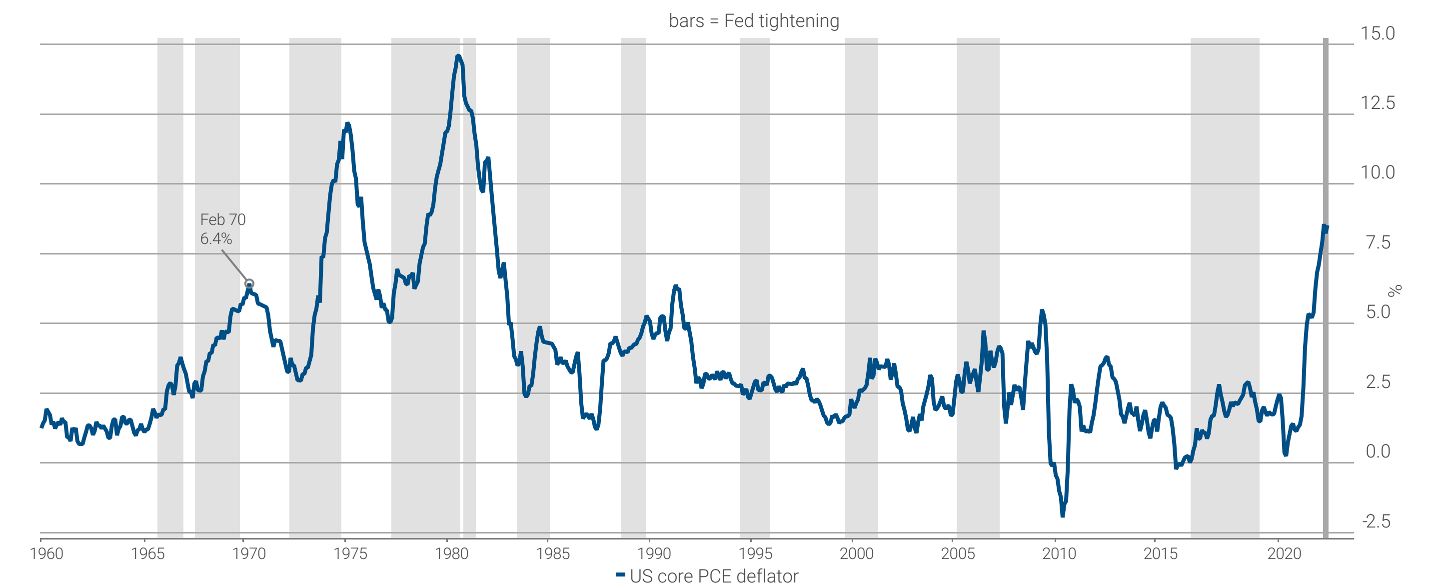
Recessionary spiral

The fundamental problem is: How can a gradual rise in unemployment be engineered without causing a recessionary spiral, when unemployment is 'too low'?

While it's plausible that merely reducing unfilled vacancies should take the froth out of the labour market, former Fed Vice-Chair Bill Dudley argued that a recession is inevitable once unemployment rises by 0.5%. This presumably reflects a loss of confidence and tightening of credit conditions as the outlook deteriorates.

In our view, a post-pandemic recovery in labour-force participation and the easing of global supply bottlenecks would help. It's also encouraging that consumers' longer-term inflation expectations have remained broadly anchored, although they have recently edged higher. And strong private-sector balance sheets should limit the extent of any tightening of bank lending conditions. So, our base case is for a 'mild' recession in the second half of 2023, which would allow inflation to settle back at target.

US core PCE rate and soft landings



Source: Macrobond, as at 28 June

Knee-jerk reaction?

The challenge for investors is to judge whether the current market weakness is the beginning of a self-reinforcing downturn, driven by recession worries, or a knee-jerk reaction to the start of Fed tightening.

Regarding US equities, we believe less recession risk is currently priced in than the headline index declines suggest, viewing a large part of these moves as more related to the surge in bond yields.

We do see scope for a rebound at points when investor sentiment is extremely negative, as US growth should hold up in the near term. What's more, we believe a soft landing that extends the economic cycle would be very bullish for US equities – and risk assets in general.

But it's also difficult to imagine sufficient data to increase confidence in that scenario significantly for a long time to come. It feels like upside to stock-market rallies will probably be capped for the time being; as a result, our team's view on equities is only modestly positive.

Hetal Mehta
Senior European Economist

Simon Bell
Senior European Economist

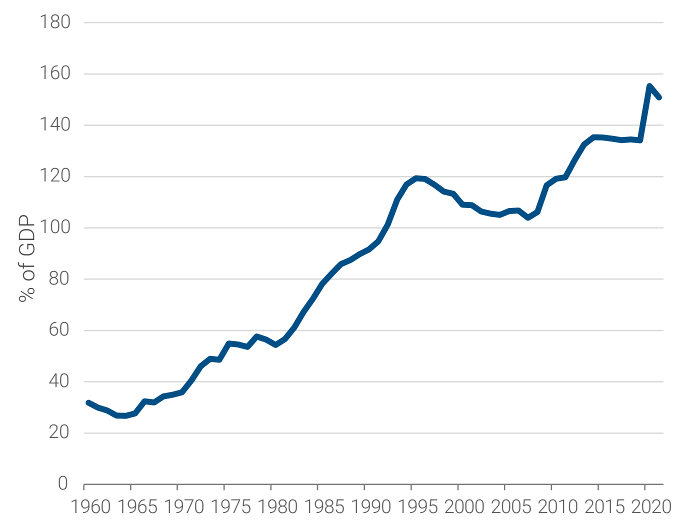
The ECB's juggling act

Most central banks are facing a dilemma of how to support growth while taming inflation, with the latter becoming the dominant priority – and policy responses moving at ever larger increments. Yet one major central bank is notably late to the rate-hiking party.

With inflation surging well above its target since mid-2021, the European Central Bank (ECB) has now strongly indicated that it will finally start this process and get rates back into positive territory by the end of the third quarter. But what has been holding it back?

In one word: Italy. In more words: After years of undershooting its inflation mandate, coming up with a plethora of unconventional tools to ease policy and periodically preventing an 'unwarranted' tightening of conditions in member countries, the ECB now needs to raise the level of risk-free rates but in a controlled, orderly way.

Italian government debt



Source: Macrobond, as at 27 June

The aggressive spread-widening in Italian bonds against those of Germany, as the market began to anticipate policy tightening, has brought concerns of market fragmentation and debt sustainability back into focus. Italy is a particular concern for investors, given its enormous debt burden. The unique institutional set up of the euro area – 19 countries under one central bank – means the ECB faces a trilemma.

Fresh instruments

In response to these concerns the central bank is now in the process of designing yet another tool to help the transmission of tighter monetary policy.

President Christine Lagarde and her fellow policymakers have bought themselves some time with reinvestments under their pandemic-era asset purchase programme to contain spreads while they work out the details. But we are yet to see how the ECB calibrates this instrument, what sort of conditions are attached to it, and whether it is subject to legal and political challenges that previous tools have endured.

If the monetary guardian delivers a credible tool, we may see a further compression of yield spreads as confidence grows that Italian debt will not become unsustainable. This would then allow the ECB to press ahead with rate hikes more in line with the other central banks. In our view, such a dynamic would likely lead to a flatter term structure, which has remained persistently steep relative to other sovereign yield curves due to the perception that the ECB would be unable to raise rates in a sufficiently pre-emptive fashion.

Finding a solution to the Italian debt problem still leaves the central bank with an acute dilemma. Trend growth across the euro area is only around 1%, and so the ECB faces more of a challenge than other central banks in controlling rampant inflation without tipping the economy into recession. We think the ECB can hike – but ultimately less than its peers.

Italian government bond spread over Germany, 10Y

Source: Macrobond, as at 27 June

Tim Drayson
Head of Economics

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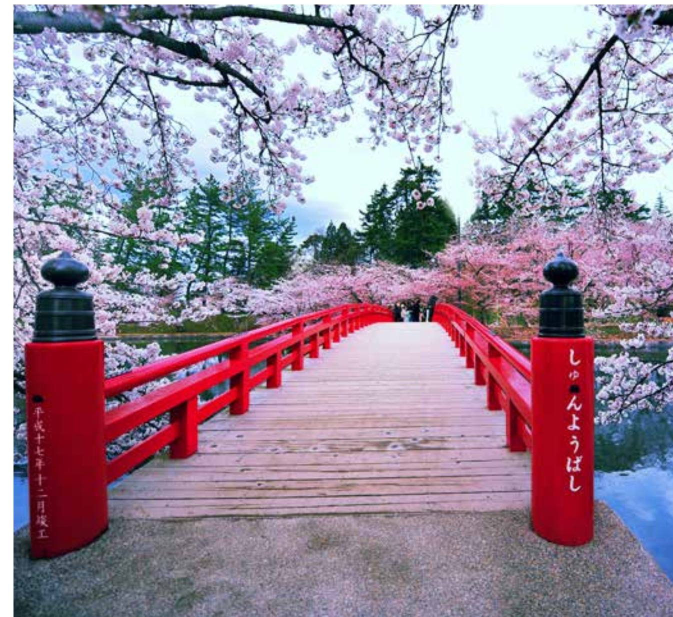
Japan versus global inflation

Japan stands out as one of the few economies that appears impervious to the wave of inflation washing over the world economy.

Headline inflation has finally breached the 2% target, but core inflation (stripping out fresh food and energy) is still below 1%, even after the depressing effect of mobile phone fee cuts dropped out of the figures. But this might be about to change for a number of reasons.

First, Japan is experiencing the same supply shocks as elsewhere. As an importer of natural gas, it can't escape the impact of the war in Ukraine. Second, the weak exchange rate is adding to imported price pressures. Also, its exports are becoming super competitive. This should add to demand.



Dollar trounces yen in the year to date

Source: Refinitiv, as at 23 June, 2022

Third, Japan has been slow to return to normal from various COVID-19 outbreaks. Mobility appears to have improved in June but remains below pre-pandemic levels. As service sector activity recovers, employment should pick up. With restrictions on international arrivals beginning to ease, there is an additional boost from net tourism of around 0.5% of GDP still to come. The labour market is not yet as tight as in other Western economies, but there is not much slack either. Improving demand and woeful demographics could generate some wage pressure.

Fourth, fiscal policy is supportive, with the July Upper House election potentially giving Prime Minister Fumio Kishida a mandate for further stimulus. Finally, Japan appears to be seeing a sharp rise in house prices which will help break the deflation psychology.

A new mindset?

What does this mean for markets? A clear break from Japan's deflation psychology could become a positive catalyst for Japanese stocks.

Households hold over half of their assets in cash and are very underweight equities. This makes sense in a deflationary environment, but if mindsets shift towards inflation, there would be a lot of room for household balance sheets to shift towards equities, re-rating the asset class in the process. We have seen no evidence of this shift happening yet, but are closely watching a number of signposts.

The Japanese government bond market has been anesthetised by the Bank of Japan's policy of 'yield curve control' which has imposed a cap on 10-year yields at just 0.25%. We think that framework is set to repeatedly come under market pressure, particularly during episodes of rising global yields. There is an inherent contradiction in trying simultaneously to drive up inflation expectations and keep bond yields contained, which we believe will eventually come back to bite the authorities.

With bond yields suppressed, the currency has become the channel of transmission – with the yen a hostage to fortune on global markets. So far, the government has been supremely relaxed about the yen depreciation. But there are already signs of public opinion starting to turn against the strategy of implicit currency debasement. Timing the end of the monetary regime is difficult, but we think upward pressure on the yen is a likely endgame.

Contact us

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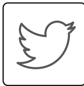

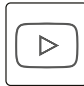

Key risks

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