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Putting the Global Economy to the Test

As recession risks rise, central banks must balance taming inflation with slower growth.

Key Points

- **We expect both tighter credit conditions resulting from the banking industry turmoil and restrictive central-bank policy to slow the global economy.** Equity valuations have actually increased against this deteriorating fundamental backdrop, so we continue to believe corporate earnings and multiples are vulnerable, and we favor defensive fixed income over equities and growth fixed income.
- **Higher market stress tends to drive up correlations across risk assets.[1] Still, we think fundamentals are differentiated in China and Japan, which we favor over the US and Europe.** We have relatively high confidence that China's reopening will support a bullish stance on its equity market. Japan should benefit from China's zero-COVID exit and from having easier policy than other developed markets.
- **We have an overweight view on duration[2] and an underweight view on growth fixed income.** We expect duration to perform well given that a US recession now seems more likely and could happen sooner than previously expected. We remain somewhat bearish on European and Japanese duration. Spread[3] valuations are slightly better but still don't adequately reflect a worse fundamental outlook.
- **Our commodities view remains positive, but we're now focused on gold.** We expect markets to shift from an inflationary to a safe-haven mindset, which we think could improve gold's upside in a highly uncertain environment.
- **Downside risks** to our views include a severe credit crunch, a deep recession in the US or Europe, and geopolitical risk involving China or Russia. **Upside risks** include a soft-landing scenario—where bank stresses are idiosyncratic and help to achieve the Federal Reserve's (Fed) inflation goals—and a decisive uptick in China's fundamentals.

Insight from sub-adviser Wellington Management

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Tighter monetary policy induced the first near-systemic fallout in this cycle as runs on two regional US banks, Silicon Valley Bank and Signature, as well as the forced sale of Credit Suisse to UBS, sparked a loss of confidence in the global financial system. As of this writing, authorities had staunched the bleeding of deposits by implementing a variety of measures aimed at ensuring liquidity and protecting depositors. But with fault lines emerging as a result of higher rates, a reassessment of the investment landscape is warranted. We think the economy and markets will face their biggest test in the coming months.

While the particulars of the bank failures may be idiosyncratic, recent events could lead to tighter credit conditions and reduce business and consumer activity. At the same time, the transmission effect of the Fed's unprecedented rate hikes has yet to fully work through the real economy. Uncertainty will predominate as policy decisions will require judgment calls based on economic dynamics not yet visible in the data. We believe a recession is now more likely and could happen sooner than we thought last quarter.

We expect volatility to remain elevated and risk assets to struggle. Thus, our broad asset class views remain somewhat defensive. We maintain our moderately underweight view on global equities, with current valuations reflecting an overly optimistic economic view. Given the risk of higher correlations across equity regions, we've adjusted our underweight view on Europe to moderately underweight and our overweight view on Japan to moderately overweight.

We continue to favor China and Asian equity markets that may benefit from China's reopening as well as from lower-priced oil imports. Government bonds have rallied but we think there's further upside, especially in the US, given attractive yields and the possibility of a Fed pivot, in which it cuts rates sometime in the second half of 2023 amid a US recession. Spreads have widened but not to levels that reflect recessionary risks. We maintain our underweight view on growth fixed income, especially in high yield and bank loans. We still have a slight overweight view on commodities but have shifted the focus from oil to gold.

The upside risk to our generally defensive view is a soft landing in which the bank failures turn out to be isolated events thanks to central banks' expanded balance sheets, credit tightens just enough to slow demand and inflation, the Fed avoids overtightening, and a recession is averted. This scenario is possible but unlikely, in our view. In fact, a seemingly benign outcome such as this might just sow the seeds of a more entrenched inflation problem and a tougher challenge for central banks.

Equities: Valuations Too High, but Pockets of Opportunity to Be Found

Our moderately underweight view on global equities is unchanged. So far, bank strains have largely had specific effects on bank equities and credit spreads rather than creating more generalized contagion across risk assets. As noted, however, we believe the probability of a recession has been pulled forward, and that credit tightening could contribute to a contraction in lending as well as in corporate and consumer spending.

Valuations of about 15 times the 12-month forward P/E ratio[4] for global equities and expected earnings growth in the mid-single digits over the next 12 months are still too high to suggest that a recession is the market's base case. Moreover, valuations in equities are misaligned with those in the bond market. Around 190 basis points (bps)[5] of rate cuts are reflected in the fed funds rate[6] curve by the end of 2024 relative to where we currently sit.[7]

Valuation headwinds could be exacerbated if, as we expect, central banks are forced to choose between controlling inflation and combatting financial instability in an environment where inflation continues to run too hot for their comfort. Margins could be challenged by a still-tight labor market but now also by a slower economy. The recent jump in accruals (the difference between net income and operating cash-flow measures) also points to the risk of earnings downgrades and reduced buybacks. Recent guidance from companies has turned more cautious as shown in the S&P 500 Index[8] negative-to-positive preannouncement ratios.

Within regions, we have the most favorable view on Chinese equities. We would expect consumer and private business spending to make up for the limited policy impulse. Business sentiment is improving, and consumer surveys show higher spending intentions across most income cohorts. Overall, we believe consensus expectations for growth in China this year are too low. Meanwhile, we think China's low correlation to other regions makes it attractive from a portfolio

Our Multi-Asset Views

Asset Class	View	Change
Global equities	Moderately UW	—
Defensive fixed income	Moderately OW	⬆
Growth fixed income	Underweight	—
Commodities	Moderately OW	—
Within asset classes		
Global equities		
US	Moderately UW	—
Europe	Moderately UW	⬆
Japan	Moderately OW	⬇
China	Overweight	⬆
EM ex China	Neutral	—
Defensive fixed income		
US government	Overweight	⬆
Europe government	Moderately UW	—
Japan government	Underweight	⬇
Global investment grade credit	Moderately UW	—
Growth fixed income		
High Yield	Moderately UW	—
EM debt	Moderately OW	—
Bank Loans	Moderately UW	⬇
Securitized assets	Neutral	—

OW = overweight, UW = underweight

Views have a 6-12 month horizon and are those of the authors and Wellington's Investment Strategy Team. Views are as of 3/31/22, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

construction viewpoint. The fact that the US dollar (USD) hasn't strengthened into recent banking turmoil is also helpful for China and emerging markets (EM) ex-China's relative performance.

In Japan, recent data shows a catch-up in services inflation, with wage negotiations resulting in the highest negotiated wage increase in 20 years. The global-bond rally has given the Bank of Japan (BOJ) more breathing room when it comes to raising the 10-year yield cap.

In the US, we don't perceive direct risks from systemically important large-cap banks, but we're focused on possible cyclical impacts if companies face tighter lending conditions. Margin normalization and higher valuations relative to other markets (compared with what we've seen historically) also weigh on the US. Our reduced underweight view on Europe stems from recent improvements in macro conditions and the retreat in energy prices. Still, the region's companies and economy are vulnerable to macro spillovers from tighter lending standards, which were signaled in the last European Central Bank (ECB) survey of credit conditions. In addition, core inflation continues to surprise on the upside, putting the ECB in more of a bind when it comes to the trade-off between inflation and financial stress.

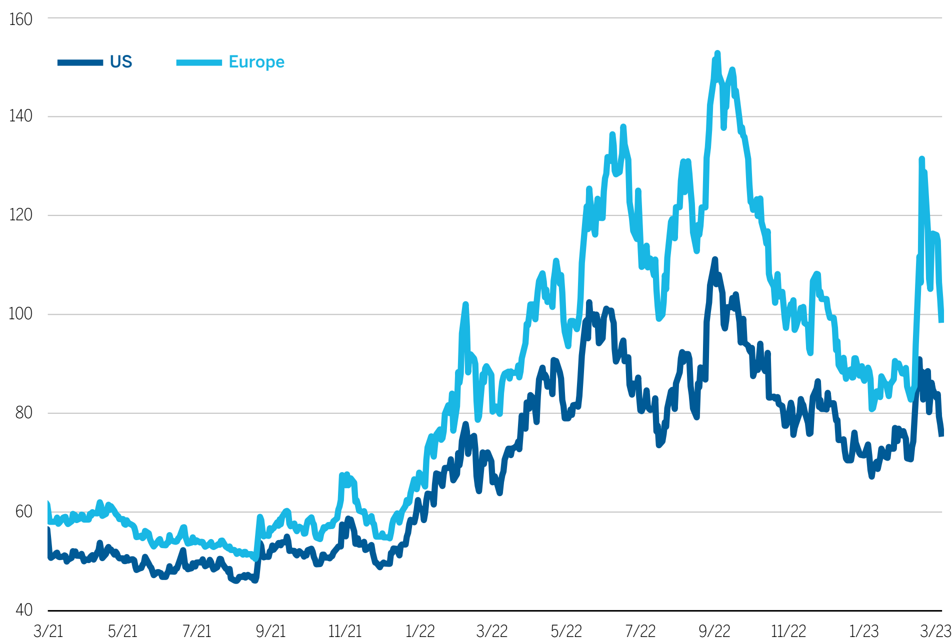
Regarding sectors, we prefer defensive sectors such as utilities and staples, as well as natural-resource equities. Technology has outperformed along with defensives on the back of falling interest rates. However, we expect more margin normalization after companies' overinvestment during the pandemic. Banks could face headwinds from an increase in funding costs, reduced profitability from balance-sheet deterioration in particular sectors of the economy, and potential tightening of capital requirements for regional US banks (**FIGURE 1**). That said, amid market shifts and restructuring in the banking industry, there's room for winners and losers, creating potential opportunity for active managers.

> Amid market shifts and restructuring in the banking industry, there's potential opportunity for active managers.

FIGURE 1

Banks Face Higher Cost of Funding

Banks Credit Default Swap Index Spreads: US and Europe bps



US: Credit Default Swap Index investment-grade financials; Europe iTraxx Senior financials. The **Credit Default Swap Index** is a benchmark index that tracks a basket of US and EM single-issuer credit default swaps. Chart data: 4/1/21-3/31/23. Source: Refinitiv.

Commodities: Taking a Shine to Gold

We've increased our view on gold from neutral to a modest overweight. This has less to do with inflation hedging, where gold's recent performance has been mixed, than with gold's potential protective characteristics amid concerns about the banking sector and recession risk. Meanwhile, our positioning indicators suggest the market isn't overweight gold.

Reflecting our expectation of a more challenging global-macro backdrop, we've pulled back a bit on our moderate overweight view on copper and moved to a neutral view on oil. Supply and inventories remain tight in both commodities; hence, our adjustments stem from an expectation of demand destruction in the short term.

Fixed Income: A Potential Haven for Safety and Return

We've moved to a moderate overweight view on defensive fixed income since we see banking troubles as a watershed event that will slow economic growth in the US and spill over somewhat to the rest of the globe.

The Fed burnished its inflation-fighting credentials with another 25-bps hike in March, despite market uneasiness, and reiterated its commitment to bringing inflation down to its 2% target. Fed Chair Jerome Powell likened tighter credit conditions resulting from the bank failures to a 25-bps hike but admitted that the extent and duration of credit tightening are impossible to know. One reason for the uncertainty is the backward-looking nature of most data. To help gauge the extent of the economic slowdown, we're watching higher-frequency data, including weekly lending activity, deposit flows, and measures of animal spirits.

We think the lagged nature of tighter monetary policy, the uncertain impact of tighter credit conditions, and the additional liquidity the Fed has added to the system increase the chances that the central bank will overtighten and exacerbate the slowdown.

If we're right, correlations to US rates could be higher, with other developed-market government bond yields likely to follow the direction of US yields. We think US rates are most attractive and most likely to come down. The market has flipped from pricing in "higher-for-longer" policy rates to pricing in about 190 bps of rate cuts from where we are today before year-end 2024, as noted earlier, but the one-year forwards imply little change in 10-year US bond yields. European government bond yields are lower and appear vulnerable to higher inflation and the rate impact of lower levels of banking stress (owing to the region's more consistent capital regulations across large and small banks). We're least bullish on Japanese government bonds. Although bond yields have fallen well below the 50-bps cap, we view risks here as being asymmetric since we think the BOJ will ultimately be pressed to loosen its yield-curve[9] control amid higher-than-expected inflation.

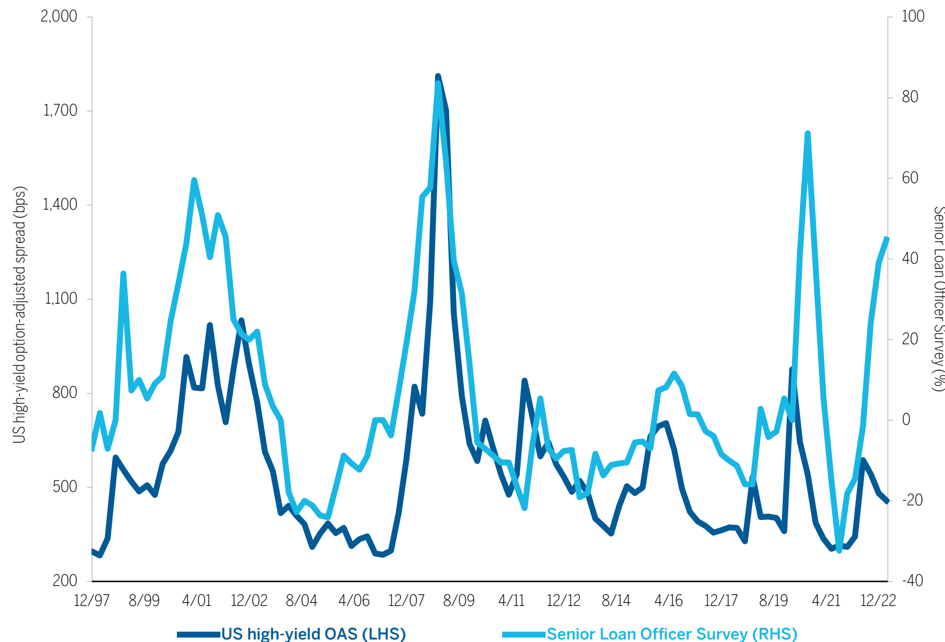
Our spread views remain largely unchanged: We have an underweight view and think allocators should focus on quality as the credit cycle advances (**FIGURE 2**). Valuations are core to our process, and spreads, while wider than a quarter ago, are still not near recessionary levels. We would need to see US high-yield spreads rise from the current level of about 500 bps to a range of 625-725 bps before we would raise our view on the market. We also maintain our preference for EM sovereign debt (USD-denominated) given its sizeable weight of around 50% in investment-grade countries. The relative value trade between high-yield and EM debt has begun to work, and we think it has further to go.

We see banking troubles as a watershed event that will slow economic growth in the US and spill over somewhat to the rest of the globe.

FIGURE 2

Tighter Lending Standards Bode Negatively for Spreads

US high-yield option-adjusted spreads and Senior Loan Officer Survey



Past performance does not guarantee future results. An option-adjusted spread is a measurement tool for evaluating yield differences between similar-maturity fixed-income products with different embedded options. Chart data: 12/31/97-3/31/23. Sources: Bloomberg Finance LP, Federal Reserve.

> A faster-than-expected pickup in Chinese economic activity remains a potential source of upside risk for the global economy.

Risks

As noted, banking stress could help central banks achieve their soft landing, but we assign a low probability to this upside risk. If recession is avoided, the recent surge in central-bank liquidity (e.g., via banks' use of US lending facilities) could find its way into valuations. A faster-than-expected pickup in Chinese economic activity (or the wider spillover effects of this pickup) remains a potential source of upside risk for the global economy.

In terms of downside risks, we could see tight financial conditions and fragile sentiment lead to further accidents in the financial sector or other vulnerable areas, such as commercial real estate. A full-blown default cycle such as that experienced during the Global Financial Crisis is another risk and isn't currently priced into credit markets. While market participants have been attuned to the risk of further escalation in the conflict in Ukraine, more dramatic developments could ensue, including a higher risk of nuclear deployment. Relations between the US and China remain on a downward trajectory and could easily spiral to new lows over Taiwan or other issues.

Investment Implications

Amid a weakening global economy, consider focusing on quality — Developed economies' resilience could be tested as restrictive monetary policy and credit tightening work their way through the system. We think the focus should remain on quality in developed-market equities as valuations have gotten pricier and earnings expectations are optimistic given our recessionary base case. We favor quality companies that can withstand ongoing inflationary and balance-sheet pressures and value-oriented sectors such as energy and materials.

Our conviction on China remains strong — We have a full overweight view on China as reopening releases pent-up demand for services in particular. We expect some positive spillover from China's recovery to other parts of Asia, but elsewhere in EMs we think higher interest-rate costs and exposure to a slowing global economy will pose challenges.

We expect correlations to increase — Regional differences may be less pronounced in a period of higher volatility. We expect European equities to feel the effects of the US banking issues, while Japanese equities could be more insulated given the country's less deflationary mindset, cheap valuations, and proximity to China's recovery.

Bond yields look relatively attractive — We think defensive fixed income could offer decent income, capital appreciation, and diversification. US government bond yields have the most room to rally followed by Europe and then Japan. We favor high-quality fixed income given that spreads in growth fixed income are still not compensating investors for recession risk.

Financial stability may be the priority over inflation — We continue to think inflation will be structurally higher, but in the near term we think the market's focus will be on credit tightening and its disinflationary effects. Within commodities, we favor gold during this period of uncertainty and maintain a slight overweight view on industrial metals, especially copper given our improving outlook on China. We also think Treasury Inflation-Protected Securities[10] breakevens could narrow as inflation slows.

Talk to your financial professional to help position your portfolio for potential market volatility.

[1] Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

[2] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[3] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

[4] Based on the MSCI ACWI Index as of 3/30/23. Price/Earnings is the ratio of a stock's price to its earnings per share. MSCI ACWI Index is a free float-adjusted market capitalization index that measures equity market performance in the global developed and emerging markets, consisting of developed and emerging market country indices. MSCI index performance is shown net of dividend withholding tax.

[5] A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

[6] The federal funds rate is the target interest rate set by the Federal Open Market Committee. This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

[7] Federal funds rate curve as of 4/5/23.

[8] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

[9] Yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[10] Treasury Inflation-Protected Securities are Treasury bonds that are adjusted to eliminate the effects of inflation on interest and principal payments, as measured by the Consumer Price Index.

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Diversification does not ensure a profit or protect against a loss in a declining market.

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