Midyear 2022 Outlook

What's Important

- **Macroeconomic Outlook:** The likelihood of a global recession has risen over the first half of 2022 as economic data has weakened. However, if a recession does occur, it is likely to be very mild, reflecting stable underlying economic fundamentals. We expect the Federal Reserve (the Fed) will continue to keep its foot on the gas over the next few Fed meetings, raising rates by 50–75 basis points per meeting at the next two meetings. For the first time in a long time, U.S. monetary policy will no longer be unambiguously accommodative. The economic outlook remains more challenging outside the United States, Europe looks headed for a recession, with bond market fragmentation a growing concern (yields creeping uncomfortably higher in peripheral countries) and growth in Emerging Markets looks weak, primarily due to renewed lockdowns in China and food inflation and insecurity.
- **Equities:** Global earnings estimates will come down, but not as rapidly as most investors expect. We believe that current EPS estimates are overly optimistic and will be revised considerably lower. This in turn will likely drag profit margins down from very high levels. We favor U.S. Equities, particularly our preference for Quality and Profitability exposure, while our expectation for higher yields and energy prices suggests a slight preference for Value.
- **Fixed Income:** Persistently higher inflation will lead central banks into action this year as all major central banks are poised to reduce accommodation via raising policy rates and ending quantitative easing programs. While global bond yields still have scope to rise over the long term, declining inflation will keep mid- and long-term rates in check near current levels. Credit fundamentals remains strong; however, the "risk-off" environment will continue further widening credit spreads.
- **Financial Markets:** A more aggressive Fed that is moving rates higher faster, slowing growth and high inflation leaves a more nuanced opportunity set for the second half of 2022. Higher rates will weigh on all asset classes, some more than others. Slowing growth, higher rates and less consumer demand will challenge earnings going forward. Positioning for equities will need to be more defensive and focus on themes such as quality and yield. Within fixed income we continue to favor shorter duration, a more barbelled maturity structure and higher-quality credit. Lastly, the combination of a Fed hiking cycle plus quantitative tightening is likely to keep volatility high across both equities and fixed income.

U.S. Macroeconomic Outlook: United States

In the United States, headwinds continue to mount for slower growth in the second half of this year. The economy lost momentum in Q2, with a more cautious consumer driving a slowdown in growth. We further saw evidence of this from the weak reading on consumer spending data. Despite weak consumer spending data, Fed Chair Jerome Powell made it clear again that the Fed will continue to hike rates aggressively to bring down inflation, even if that means risking a recession. We still expect the Fed to raise rates by 50–75 basis points at the July and September meetings.

Our base case for the second half of 2022 is for weaker growth as consumer spending data slows and inflation remains high. The most recent inflation report in May still shows that we continue to have supply chain disruptions, high food and energy prices, and high housing costs. This has taken a toll on the consumer as consumer confidence continues to fall to new lows. Waning consumer confidence argues for a consumer who is more diligent with how they spend their money if their view of the economy is pessimistic. Despite this weakness in confidence, we do see consumer spending continuing to shift from goods to services. This shift should ultimately ease demand-side inflationary pressures on goods, which ultimately may temper the Fed's hawkishness later this year.

A bright spot in the economy continues to be the labor market. Labor demand remains historically strong, as there are more job openings than available workers. With the Fed embarked on its most aggressive tightening campaign in nearly three decades, a

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slowing economy should help bring worker demand and supply closer into balance. We also believe as workers see higher wages and dwindling savings, that will push sidelined workers to rejoin the workforce, helping to keep the labor market resilient.

The economic outlook for the United States has certainly grown cloudier. We are now faced with high inflation, and faster-than-expected Fed rate hikes have left a consumer who has lost confidence. This presents a challenging growth picture for the remainder of the year, since consumer spending represents 70% of growth. However, the combination of a strong labor market and a consumer who is increasingly willing to spend on services will help cushion the blow to growth. We view sustained inflation as one the biggest risks to watch for in the second half of the year, as the Fed will keep raising rates aggressively until it has seen some evidence that inflation is slowing.

U.S. Macroeconomic Outlook: International

International growth outside the United States remains weak. Europe is struggling with energy shortages both from a manufacturing perspective as well as Russia's retaliation for natural gas supplies due to sanctions. China is suffering from a confluence of issues, from its strict COVID policies hampering manufacturing that have led some companies to find other places to produce their goods, to a property market that continues to show significant weakness.

Europe has an energy problem, and for some European countries, it's worse than others. This will most likely leave Europe in a recession later this year. Germany went as far as to activate a plan where it may start gas rationing, given its reliance on Russia for natural gas. Europe as a continent has committed a lot of funds to energy independence from Russia, but this has come too late in our view. Increased fiscal spending in Europe will keep fiscal policy looser and will give some support to the Euro area economy. Despite looser fiscal policy, we believe the overwhelming energy issue will point toward a European recession.

Emerging markets (EMs) as a group will continue to be hampered by a slowdown in China. The outlook for EMs outside of China looks to be uneven; emerging Asia may benefit when China's lockdowns end, while recession risks have increased for Latin America due to tight monetary and fiscal policies. For China, the stop-start supply chain issues have brought manufacturing to a standstill and left corporates rethinking where they want to produce their products. Still the biggest Chinese risk, in our opinion, is the risk to a weaker property market. There is the risk that the property market declines too quickly, which would put significant stress across the Chinese economy. Overall, the shift in supply chains potentially out of one EM country to a non-EM country plus a stronger dollar will hamper EM growth.

Financial Markets Outlook

As the odds of a recession have increased, the environment for equities will become more challenging. Higher rates continue to weigh on equities, and we have seen a significant derating in equity multiples. While Q2 earnings are likely to be OK, we think second-half-of-the-year earnings will need to be reevaluated down, as a weaker consumer will weigh heavily on the demand for goods. Relative measures between equities and fixed income continue to shrink. The equity risk premium (equity yield minus the risk-free bond rate) continues to favor stocks over bonds but not nearly as much as when we entered 2022.

As we enter the summer earnings season, an important measure to watch will be guidance. We expect corporate guidance will increasingly be negative, leaving lower earnings for the rest of the year. U.S. profit margins remain elevated, we believe, as consumer demand slows and corporates can't keep passing on higher prices that will lead to profit margin compression and further hurt earnings. We expect the second half of 2022 to be characterized by a fundamental bottoming process, during which corporate fundamentals and expectations are pared back to reflect a more challenging macro backdrop. This should continue to produce elevated periods of volatility and augurs for more defensive posturing.

Our fixed income view remains unfavorable as the Fed will continue to raise rates until it sees signs that inflation has slowed. We also have a Fed embarking on quantitative tightening, which has never been done in conjunction with a Fed hiking cycle, and we believe the combination of the two will add to bond market volatility. As the Fed continues to raise rates, the yield curve will further flatten from current levels, with parts of the curve to potentially invert. We also expect other central banks globally to follow the Fed's lead in raising rates, however at a much more muted pace.

Credit market fundamentals remain stable but are under significant pressure from the risk-off environment leading to wider credit spreads. However, credit spreads in the high-yield space will remain under greater pressure and widen further, as expected default rates have moved significantly higher since we entered 2022. Municipals have lost some of their relative attractiveness from where we started the year, and we have a neutral view. We continue to recommend short duration positioning, as we believe the Fed will continue to push rates higher, therefore hurting longer duration bonds, and we suggest having less credit exposure as higher rates will take spreads wider.

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Portfolio Positioning

Given the market turbulence and a rising probability of both a recession and stubbornly high inflation, we think portfolios should be underweight long-term strategic allocations to equities and overweight allocations to cash for now. We see opportunities to diversify income sources and raise the quality of portfolios during this volatile period across asset classes. We believe there will be opportunities to rebalance into higher-quality assets later in the summer. Where possible, alternative assets like hedge funds, commodities and private credit investments are attractive additions to portfolios.