7-July-2022

Monthly Market Musings: Slowing growth and the elusive inflation peak

- High inflation means central banks continue to aggressively tighten policy into a slowing global economy.
- Bond markets have dramatically swung between inflation and growth risks over the last month.
- The H2 outlook for bonds appears more balanced, but a major turning point for yields could prove elusive while inflation is yet to peak.

H1 2022: historically poor performance for most asset classes

Most asset classes performed poorly over the first half of 2022. Equities, sovereign bonds, and credit experienced significant losses. In the case of the Bloomberg US Treasury and Global aggregate bond indices, the 6m return was the worst on record. Some notable market exceptions were the USD and select commodities. Rising central bank policy rates have improved cash returns in most markets.

Chart 1: Select asset performance in H1 2022

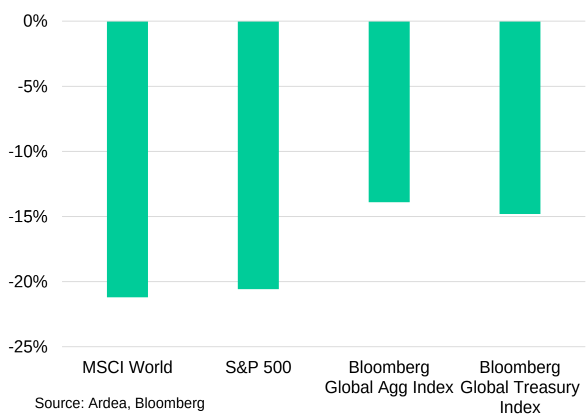
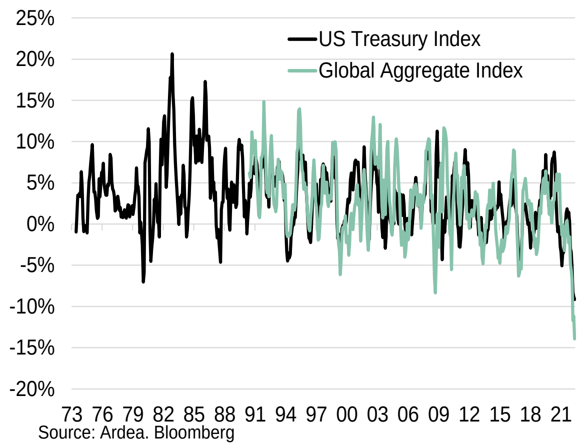


Chart 2: Rolling 6m bond returns

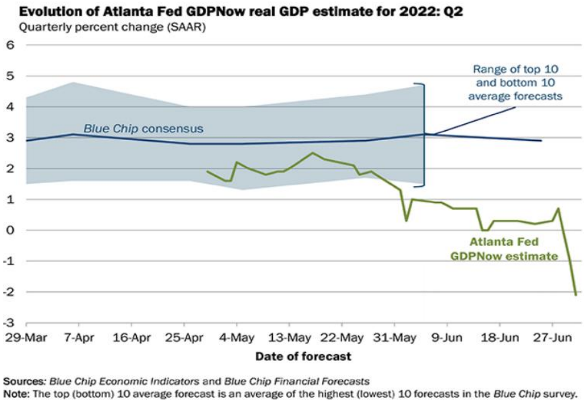


H2 2022 Themes: Slowing growth and the elusive peak in inflation

In H1, inflation data surprised central banks, investors, and economists to the upside. As H2 begins, inflation is still elevated, but downside surprises to growth are becoming just as concerning for markets. The global economy is slowing and the risk of recession in major economies is rising.

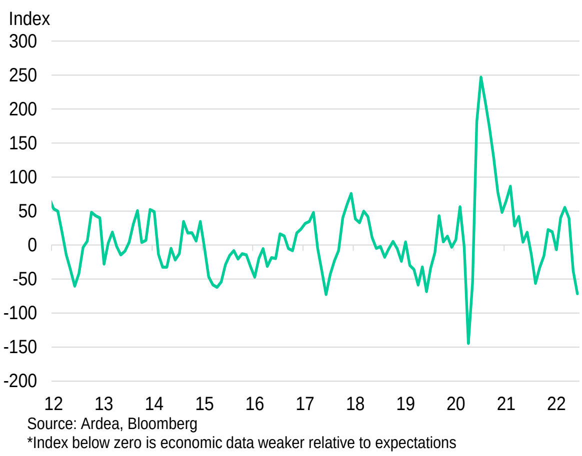
Markets have latched on to weaker US activity data over the last few weeks, some of which suggest the world's largest economy is contracting for the second consecutive quarter. For example, the Atlanta Fed's GDPNow tracker, which brings together more micro data points, suggests annualized GDP growth of -2.1% in Q2 - a sharp drop in a short space of time (the official figures are released in later in July and forecast errors average around 1% for this indicator).

Chart 3: US Q2 GDP Now estimate



There is lots of noise in short term activity data and the underlying picture is not as bad as this indicator suggests, but there are other signs of softness. For example, US housing and consumer confidence indicators deteriorated over the last month, which generally foreshadow broader weakness in the economy. Negative real income growth on account of surging inflation and aggressive tightening of monetary policy are starting to impact consumers and many economists are downgrading growth forecasts. The US data surprise index has dropped over the last two months (Chart 4), indicating the balance recent data releases has significantly undershot market expectations.

Chart 4: US data surprise index

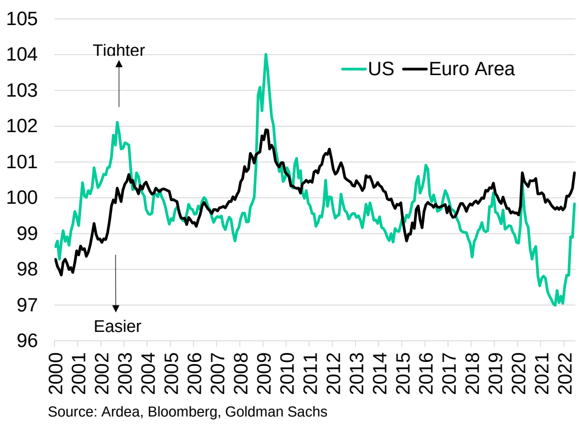


On the more optimistic side is the current low level of US unemployment, but this is a lagging indicator. Some market analysts highlight the steady uptick in the US weekly jobless claims series of about 60k over the last two months (from record lows) as indicating that higher unemployment is on the way.

Other indicators – such as the inversion of the US 2s10s yield curve – are pointing to higher recession risk. We discussed this indicator and its pitfalls in our April note. Yield curves and other models are suggesting a wide recession probability range of anywhere from 30% to 60%. Some investor surveys suggest up to 90% odds by the end of 2023 but much lower at around 20% for 2022 (the unconditional probability of a recession can be thought of as about 15% at any time given the frequency of past recessions).

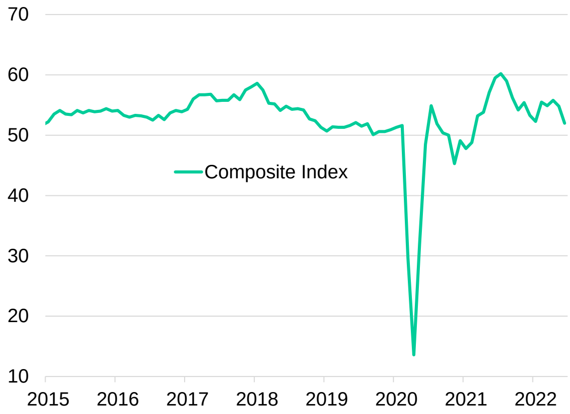
The trend in data may indicate rising recession probability, but at the end of the day the timing and severity – also key questions for investors – remain open questions that will come under greater scrutiny in the coming months as the Fed tightens policy further. Financial conditions are already at near the peak seen through the 2018 Fed tightening cycle (Chart 5).

Chart 5: Financial conditions indices



Signs of a growth slowdown are also evident in Europe, as PMI surveys surprised to the downside in June (Chart 6). The forward-looking components of the survey, such as new orders and business expectations fell sharply.

Chart 6: Euro Area Composite PMI



Source: Ardea, Bloomberg

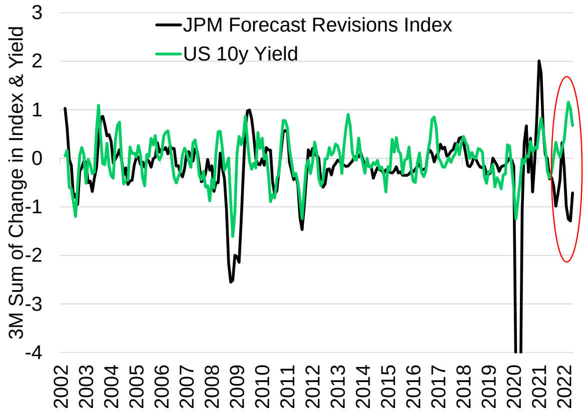
The outlook for Europe is further complicated by two substantial downside risks:

1) The risk of an energy crisis after Russia recently cut natural gas exports to Germany, citing technical reasons.

2) Financial "fragmentation" risks – defined broadly as severe widening in peripheral bond spreads to core markets as the ECB hikes rates and reduces QE (and therefore uneven transmission of policy tightening throughout the Euro Area). The ECB has flagged bond purchase tools to fight the risk of dislocation in peripheral bond markets.

At a broad global level, forecasts for 2022 growth continue to be revised lower. Some private sector economists look for advanced economy growth in 2022 of just 2.5% - less half the pace of 2021 (as noted in 5 Key Themes for 2022, the consensus to start the year was for growth to slow to only around 4.5%). Similarly, the JP Morgan global growth revisions index implies forecast reductions of around 1.5% over H1. As Chart 7 shows, the gap between changes in growth revisions and bond markets reflects the high inflation environment.

Chart 7: Global growth revisions and the 10y bond yield

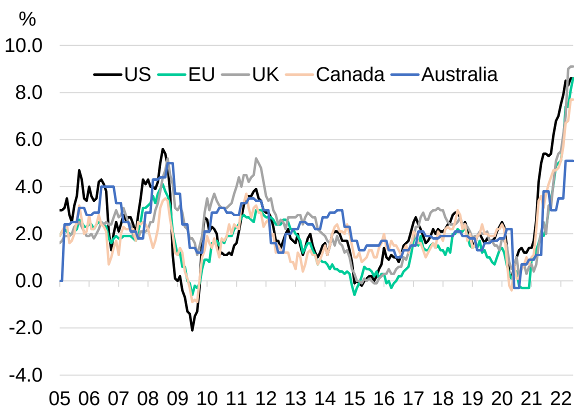


Source: Ardea, JP Morgan, Bloomberg

High inflation means central banks have been aggressively tightening policy into a slowing global economy. Early June saw another step-up in hawkish intent with the Fed hiking 75bp, the RBA hiking 50bp (and again in early July) and the ECB foreshadowing the start of a hiking cycle in the coming months.

US, UK and European headline inflation is running 8-9% y/y and for Australia is expected to rise from 5% to 7% y/y over H2. Core inflation measures are running at lower levels but have recently shown signs of second round effects from the high headline measures. There has also been a general broadening of price rises in most countries. For example, prices for over 60% of the US CPI basket are rising at 5% y/y or more.

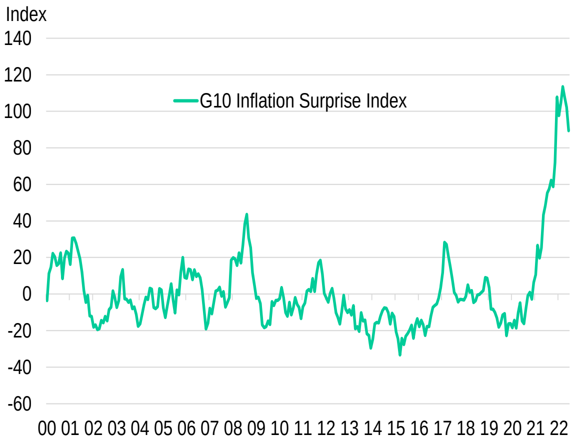
Chart 8: Global headline CPI (y/y)



Source: Ardea, Bloomberg

High inflation will take time to come back down towards more normal levels, consistent with central bank targets. However, the balance of risks for central banks between high inflation and slowing growth could start to tip once there are genuine signs inflation has peaked, in the context of economies slowing more rapidly than earlier expected. Timing of this peak has proven to be among the most difficult of tasks in 2022, as the inflation data surprise index near record levels attest (Chart 9).

Chart 9: G10 inflation surprise index

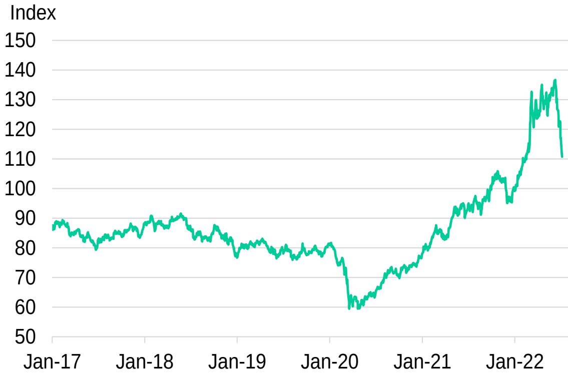


Source: Ardea, Bloomberg
*Index below zero is inflation below expectations

Notwithstanding recent challenges, many forecasters now see the inflation peak in Q3 or Q4, which if accurate, will shift more focus towards the worrying growth tail risks. This outlook is generally predicated on some combination of the following big assumptions:

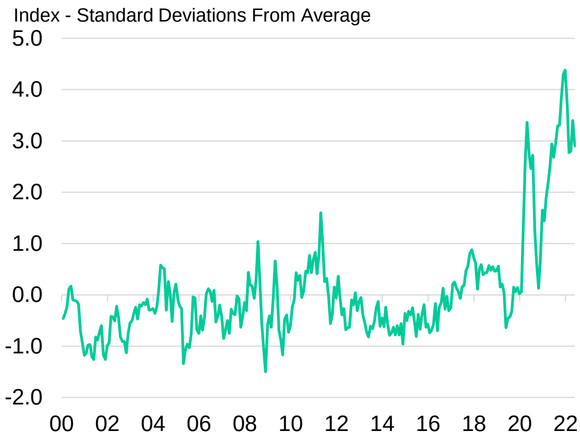
- energy price base effects fading and lower commodity prices – which have fallen sharply in recent weeks (Chart 10):
- supply chain pressures continuing to ease (Chart 11 shows the starting point is still elevated); and
- softer demand limiting wage-price pressures.

Chart 10: Bloomberg commodity price index



Source: Ardea, Bloomberg

Chart 11: Global supply chain pressure index



Source: Ardea, NY Fed, Bloomberg

Implications – bond outlook more balanced than H1, but risks and volatility to remain elevated

After the historically large underperformance in H1, the worst period for bond returns may have passed.

That doesn't mean yields can't still make new highs in H2 – as they have tended to do beyond this point in prior tightening cycles. But the broader outlook for bonds has improved relative to H1 for a few reasons:

- Forward curves are priced for restrictive monetary policy levels in most markets (Chart 12).
- Long term real and nominal yields are at levels that can provide some hedge value

against weakness in riskier assets.

- There are signs of a slowdown in growth underway (as outlined above).

Chart 12: Current and forward cash rate pricing

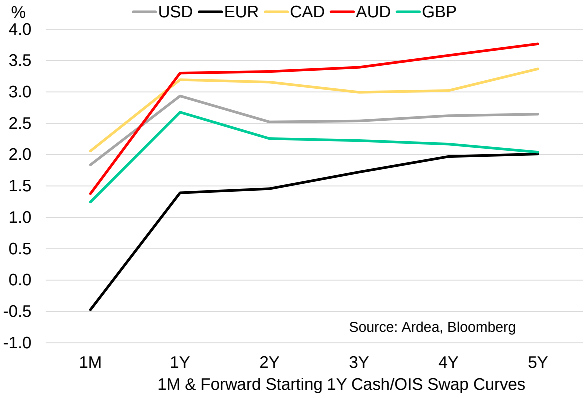
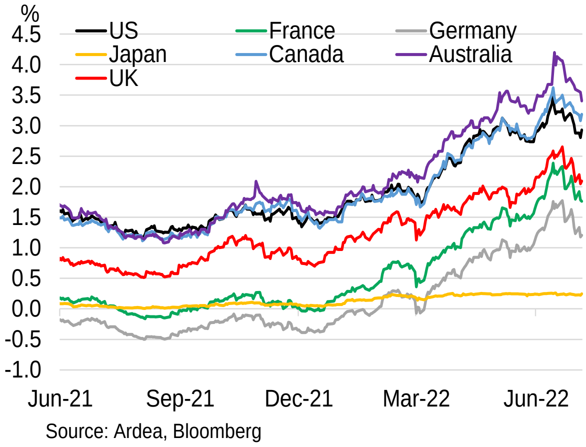


Chart 13: Global 10y yields



Against these factors, the missing piece is a meaningful turn lower in inflation data (as we have discussed in prior notes). For this reason, we continue to think the large two-sided tail risks of recession or prolonged high inflation are likely to see bond (and equity) volatility remain elevated. As we have seen through June, with the market lurching from fears over high inflation to weaker growth in the space of a few weeks taking global 10y yields to new cycle highs before falling up to 60bp (Chart 13).

Cross market divergence in interest rate curves could become more apparent in the coming months. For example, the significant downside risks in Europe from energy and fragmentation issues highlighted earlier could further complicate ECB tightening plans. As Chart 12 shows, Europe and Australian forward curves are steeper than peer markets on account of a slower start to policy tightening, while other markets are pricing some risk of easing over the next 1-2y years.