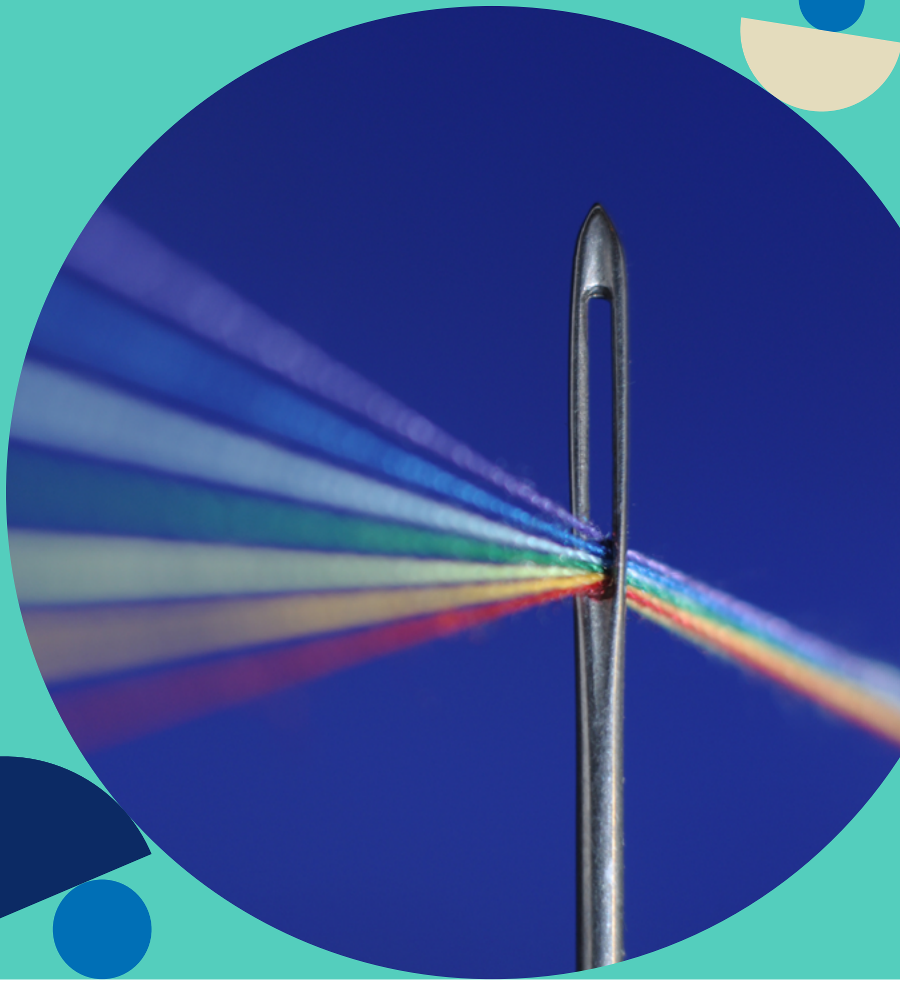
ZURICH

Mid-year Outlook 2023

Threading the needle



The first half of the year saw a number of cross currents at play, yet we close the period with economic growth having been resilient, headline inflation plunging, a systemic banking crisis averted, and equity markets back in bull-market territory. This is despite core inflation proving considerably more troublesome than expected and global policy rates powering relentlessly higher. Can the central banks thread the policy needle and maintain the expansion while taming inflation, or will the delayed impact of spiking rates mean that activity is like Wile E. Coyote in the Road Runner cartoons, having run off the cliff but yet to plunge?

The key factor behind the better than expected growth has been the strength of consumer spending globally, helped by the remains of the pandemic's excess savings being put to work against a backdrop of full employment in many regions.

Service sector activity has been stellar, but after the boom around the pandemic, manufacturing is in recession and global trade in goods is contracting in a highly bifurcated global economy.

While the penal rate environment could have been expected to unsettle investors, the combination of light portfolio positioning in risk assets at the start of the year, less-bad earnings than feared, and hopes of a soft landing for the global economy, spurred equity and to a lesser extent credit markets higher. Despite the banks failing to recover from the trials and tribulations of March, with the KBW banking index still down 20% in H1, and corporate defaults rising, the alure of AI seduced investors into technology stocks and helped drive momentum in global equity markets. Indeed the MSCI World Index is up 13%, and many regional markets have rallied more than 20% from last year's lows.

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Stocks perform well, but the banks are shunned

Source: Bloomberg Rebased to 100, Jan 1st 2023

Despite this, we continue to see growth and market troubles ahead, as central banks battle with bringing core inflation down to a credible flight path. Threading the policy needle will be difficult. It could be accomplished if economies really are resilient enough to withstand the high rates without fatal blows being inflicted to underlying economic conditions, and inflation declines abruptly. This growth element, however, seems unlikely given the scale and lagged effects of tightening. We see recession in both the US and Europe as probable in the second half of the year as the services sectors finally follow manufacturing into contraction and the cost of money bites. Encouragingly, a number of emerging markets, including China, look like they're in better shape and will offer some off-set to the slowdown.

Government bonds remain attractive with yields not fully reflecting weakening inflationary pressures, slowing growth, and rising financial market risks. Credit markets in contrast are particularly vulnerable currently as defaults have started to rise and refinancing costs have jumped, while credit spreads have remained tight. Stock investors seem complacent with exposures having been increased, and valuations are stretched. Falls are expected as recession becomes clearer and earnings decline more than anticipated.

Growth has been stronger than expected

Despite record tightening of global policy rates, and the banking stresses that have contributed to a marked reduction in the willingness to lend, economic activity has been resilient in H1. The mild recession in the Eurozone, with growth contracting in Q4 last year and Q1, was much less severe than it could have been, as the region was spared by a plunge in natural gas prices from the highs of last August of €340 per MWh, and adequate supply over the mild winter months. However, conditions remain extremely fragile with gas prices likely to have bottomed recently at €23 per MWh and now rising.

More broadly, the surging rate environment has had more of a lagged effect than expected, partly perhaps as a result of many mortgages offering some form of fixed rate component, while a lack of new homes in key markets such as the US, UK and Australia has helped to support prices and keep the construction industry active. This is starting to change, however, as many mortgages outside of the US have fairly short fixed terms and will need to be refinanced at much higher levels. UK banks have been persuaded by the government to delay repossessions by 12 months, but stresses are clearly going to rise. Corporate borrowing has also been manageable so far, with maturities having been termed-out at low rates, though here too change is afoot. Senior loan officer surveys in both the US and EU show tightening lending standards and a dramatic decline in loan demand, which have been good leading indicators of economic health in the past. This is having a significant impact, particularly on small and medium-sized enterprises, where bankruptcies are now picking up. Business investment is also drying up, with funding costs rising and returns harder to come by, which will impact already poor rates of productivity.

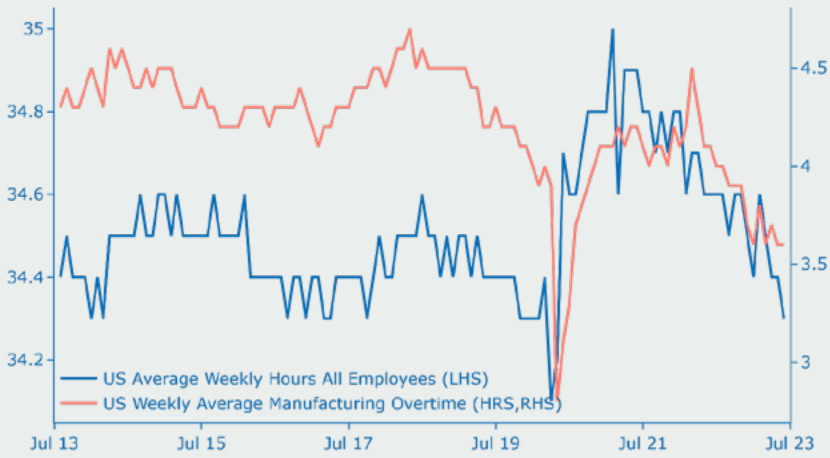
Jobs are now at risk

A consistent trait globally has been how durable the labour markets have been. Many regions are running close to full employment, with unemployment rates at multi-decade lows. Employers appear to be hoarding labour, given the difficulties in recruiting since the pandemic, despite slowing sales and falling margins. However, employment is typically a lagging indicator and is generally at its cycle low just as recession hits, before lurching higher as labour shedding becomes ubiquitous and companies try to shore-up earnings. While jobs remain tight, early warning signals are flashing.

The US labour market has been particularly strong, yet hours worked and overtime have been moving markedly lower, while the number of people quitting their jobs to seek better terms elsewhere has now also turned lower. The US is one of the few economies that has seen a notable pickup in legal immigration since the pandemic, which should help support labour supply and activity over time, in contrast to the UK economy where labour supply is particularly acute. Growth in average hourly earnings in the US has subsided to 4.3% YoY, Eurozone readings are 4.6%, while the 7.2% reading in the UK is forcing the BoE to act with greater vigour.

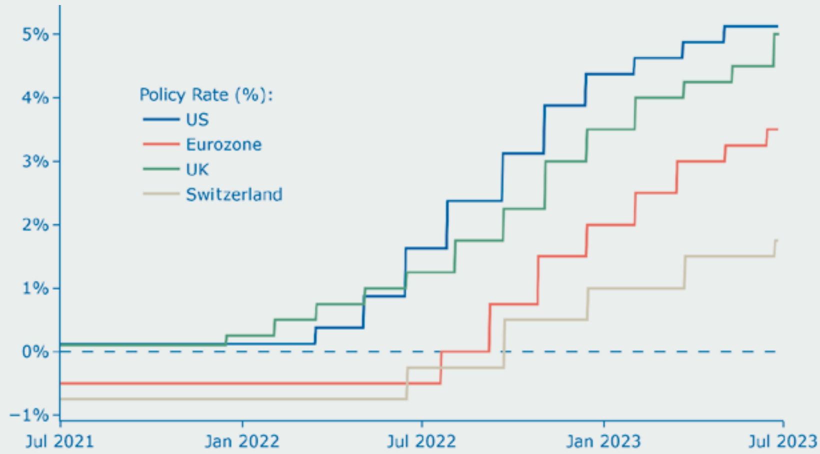
Growth in average hourly earnings in the US has subsided to 4.4% YoY, Eurozone readings are 4.6% while at a very elevated 7.2% in the UK.

Leading US job indicators have rolled over



Source: Bloomberg

Rate hikes have been unrelenting and are starting to hurt



Source: Bloomberg

Damned if you do, damned if you don't

Indeed, the biggest risk to global growth is that central banks overdo tightening, potentially turning our moderate recession view into a more substantial decline. From a credibility perspective, their fear is that they do too little and inflation fails to be tamed, while the risk of doing too much is one of recession - something all central banks are familiar with and well equipped to tackle. Currently core inflation readings in developed economies remain extended, despite the sharp fall in headline measures. As inflation is a global phenomenon, there seems to be more coordination evident from the policymakers as rate moves and rhetoric appear aligned to 'crush the beast'.

While wages have failed to keep pace with inflation in most regions, resulting in a painful squeeze in real incomes, wage growth is a concern. With productivity having plummeted, inflation expected to ease and high wage demands remaining, it seems that the only sure-fire way of preventing a potential wage spiral is for unemployment to rise. Consequently, global activity either needs to quickly decline to quell inflation, or be forced to do so by the policy makers, thus creating a regime that seems to be one of `damned if you do, damned if you don't'.

US recession remains on the cards as rates start to bite

Looking at the key regions, the US is the linchpin for our recessionary outlook. Despite the modest expansion so far this year, a number of key variables are deteriorating and are expected to worsen. The ISM Manufacturing Index has been in contractionary territory since November, and empirically it is a good indicator of where the much larger services part of the economy is heading. Here, the divergence with services is closing, with the latter indicator now also teetering on the brink of contraction. Small business optimism is at a 10-year low and falling, while new order indices also show caution. One of the critical components of demand has been the excess savings rate which had represented around 10% of the US economy at its USD2.2tn high last summer. According to the San Francisco Fed, this is now estimated to be around USD500bn, with most households likely to have spent their windfall. This seems to be corroborated by rising credit card balances, which carry a whopping 21% interest rate, as well as comments from Walmart, noting that customers are trading down in terms of spending.

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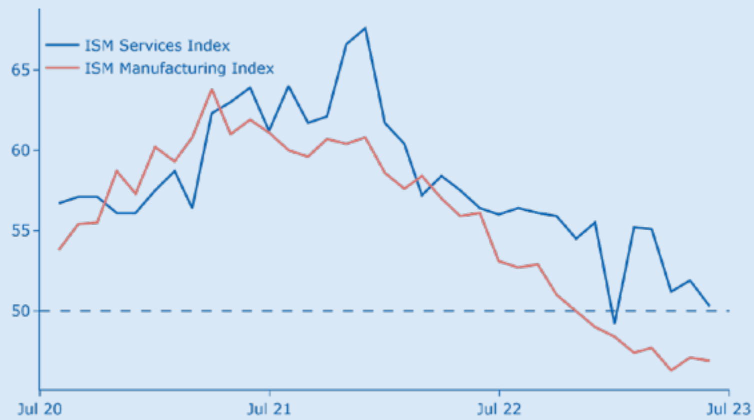
US service sectors are now also looking vulnerable



Source: Bloomberg

US recession remains on the cards as rates start to bite
(Continued)

Perhaps most concerning is the Fed's talk of a further two rate hikes after the June pause. We suspect that it may have to follow through in July in terms of maintaining credibility with a final 25bp hike, but both inflation and growth will be showing notably lower readings thereafter, warranting the end of the hiking cycle. We believe the economy will contract modestly in both Q3 and Q4, before heading back towards trend growth later next year in a subdued recovery. Where could we be wrong? Should the labour market continue to hold in and inflation falls more rapidly than expected, this could buoy sentiment and spending, while stabilisation in the housing market would offer a further fillip. The trouble is that there is so little spare capacity, future growth would lead to further supply shortages and potentially higher inflation. Consequently, the issue of recession is really more one of timing rather than probability.

The Eurozone is a weak and fragile land

The Eurozone escaped a deep recession over the winter, but has contracted nonetheless with prospects still subdued and vulnerable, while inflation remains troublesome. The ECB has been clear in its resolve to tame inflation, with 400bps of rate hikes so far, and another 50bps expected by September, marking the most profound hiking cycle in the Eurozone's history. This seems reasonable as unemployment is around record lows, while risks to wages remain to the upside despite the anaemic growth environment. An additional headwind, however, will be the repayment by the banks of funds from the TLTRO lending facility which are expiring. In June, around €500bn was repaid which will be replaced by higher cost funding. This is adding to the already tight financial conditions in the region, where loan demand has slumped to the lowest levels since 2008. As in the US, the services sector is now following manufacturing lower, with France notably weak with a PMI Services reading in contractionary territory at 48.0.

We continue to expect the Eurozone to muddle along in a mild recession over the remainder of the year, with risks to the downside. The stickiness of inflation is likely to constrain any policy support from the ECB even as growth contracts, and rates are expected to be on hold into 2024 following a final hike in September. The UK faces an even more challenging outlook, with the labour market particularly tight, wage growth running at the highest level in decades outside of the pandemic, growth stagnating and the housing market softening as fixed rate mortgages run off. We see the BoE hiking by a further 50bps in August, but expect inflation rates to fall quickly thereafter with growth contracting.

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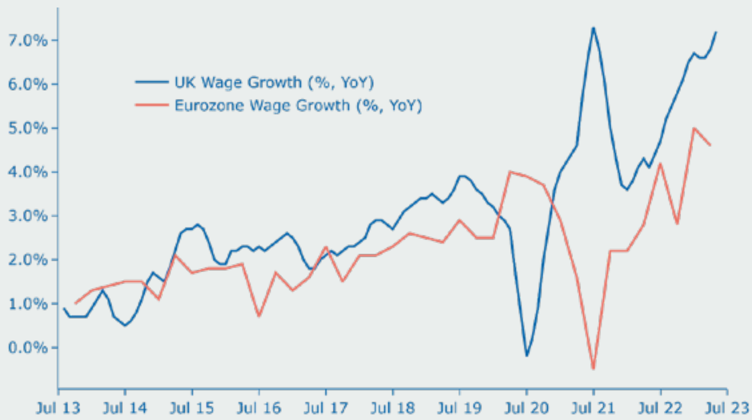
Wage growth poses a problem for policymakers



Source: Bloomberg

China bucks the trend

After a strong start to the year on reopening from Covid restrictions, the Chinese economy has underwhelmed in recent months. The fall in global demand for manufactured goods has been a blow, while the housing market has resumed its slide. Inventory of unsold homes has improved, but the market in general is stagnating and requires further policy action. Down payment ratios for new and existing homes have been cut, resale time restrictions have been shortened and the one and five-year lending rates have been cut by 10bps. Given the extent of the issues, we suspect more needs to be done in the months ahead as the property sector represents around a third of China's economic output. Private investment has also faltered, while the move higher in youth unemployment, now exceeding 20%, is a concern. Despite these issues, the economy is still expanding at a decent clip, with domestic consumption recovering and services also doing well. Inflation is at odds with much of the rest of the world, with CPI at 0.2% YoY and PPI deeply into deflationary territory, thus the authorities have the latitude to cut rates further and provide more targeted monetary and fiscal support. While growth is a little disappointing we expect it to modestly exceed official government forecasts of 5%, providing a much needed cushion to slowing growth and recession in other regions.

A mixed picture in Asia

This is also true in other parts of Asia, where Japan is likely to perform relatively well in the second half, albeit at a slower pace than in H1. Consumption and capital expenditure should lend support, with decent real wage growth expected following robust pay negotiations and fading inflation. It seems likely that the yield curve control measures designed to boost growth will be adjusted. While remaining stimulative, we expect the zero percent band around 10yr yields will be widened from 50 to 100bp. In contrast, Australia has a more Anglo Saxon dynamic, with further rate hikes expected in light of troublesome core inflation and rising unit labour costs, with the critical housing market showing signs of renewed price appreciation. At least one further rate hike appears likely before the trajectory is reassessed.

LatAm has taken its medicine

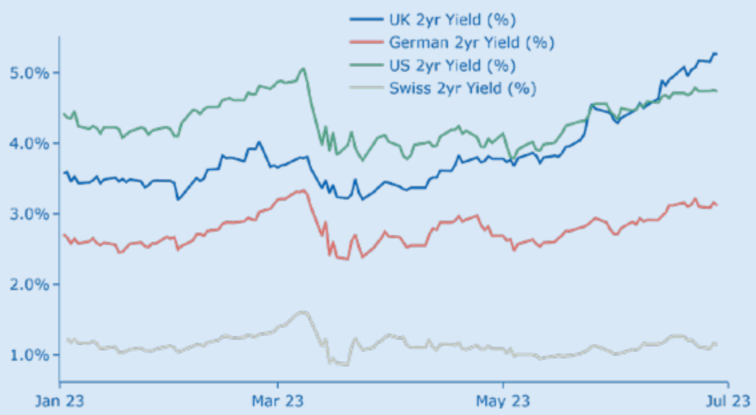
Latin America is in slightly better shape, having been early in the rate hiking cycle, with Brazil starting a full year before the Fed and hiking by 11.75%. With the exception of Argentina, inflation is encouraging, while the growth outlook is improving and we expect rate cuts in the months ahead by both Chile and Brazil. Though global growth is expected to be meaningfully below trend both this year and next, better prospects are evident beyond the G7 nations.

Bonds offer attractive returns and a safe harbour

Risk assets have had a much better H1 than we had anticipated, with the economic growth environment proving stronger than expected, and earnings less-bad than feared. This occurred against a backdrop of poor investor sentiment and light positioning that lent itself to a rally in both equities and credit markets, while yields for benchmark 10yr government bonds drifted marginally lower. Looking forward, we see a further move lower in yields from current levels. Inflation has declined appreciably since the start of the year, and growth is slowing, leading us to suspect that monetary policy will become less of a headwind. In addition, the front end of curves are looking appealing and attracting fund flows given the steepness of the inversion.

With US 2yr Treasuries offering a risk free rate of 4.8%, bonds are again offering good value and an alternative to risk assets, particularly in light of our recession forecasts and their safe haven status. Within bond markets, gilt yields have jumped on the elevated UK inflation print and higher policy rate expectations. This is becoming stretched relative to other core bond markets, such as the US and Switzerland, as a more forceful policy approach from the BoE is likely to curb the inflation dynamic and push yields back down in the months ahead.

Short-dated bond yields offer attractive risk-free returns



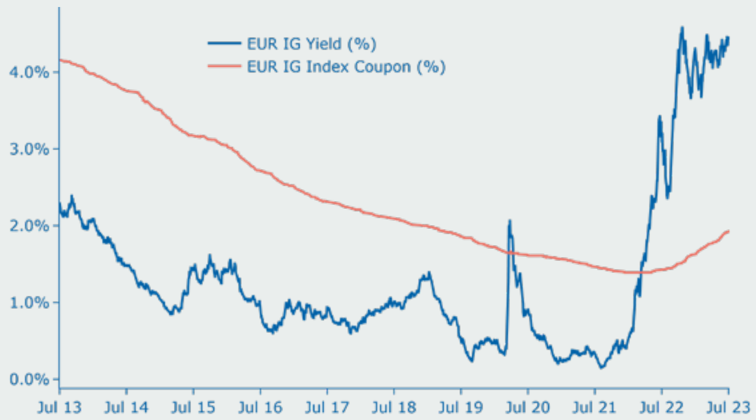
Source: Bloomberg

Credit investors appear to be in denial

Though credit markets underperformed equities in H1, they are looking expensive on most fronts. The banking turmoil back in March did roil markets, but spreads have tightened since then as the risk of a systemic banking crisis has dissipated. That noted, the possibility of a credit crunch is very real as banks remain exposed to rising credit defaults, and deposit outflows in search of better returns elsewhere are substantial.

Importantly, financing conditions have deteriorated significantly over the past year, and while European High Grade companies could issue debt sub 0.5% only 2 years ago, that has now jumped to 4.5% as government bond yields have surged despite credit spreads remaining tight.

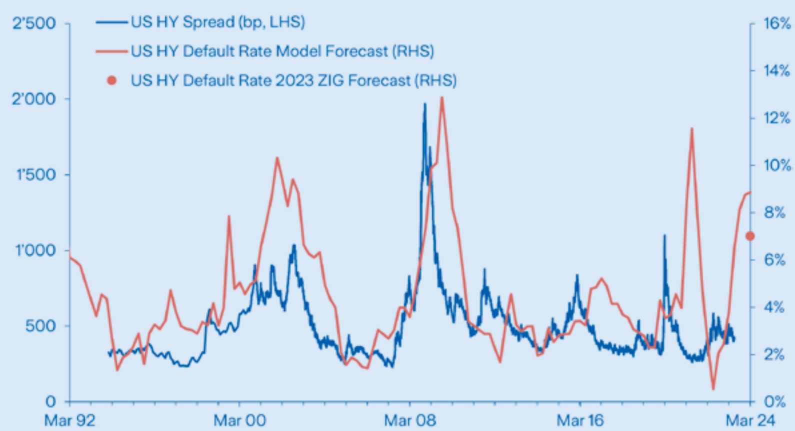
Cost of borrowing spikes even for high quality companies



Source: Bloomberg

High Yield spreads look particularly stretched in light of tightening lending standards, which would imply spreads of between 800 to 1,000bps if history is any guide, rather than the current 450bps. Our analysis also points to rising defaults on both sides of the Atlantic. In the US the run rate of announced defaults YTD implies the count for 2023 could rival that seen in 2020 and close to that in the financial crisis. Although we have raised our default projections in the US to 7% from 5%, this is still below prior recessions and acknowledges better duration profiles and the locking in of attractive rates. Nonetheless, this is a substantially higher rate than investors have become accustomed to in recent years. As we look towards the end of the year, IG credit is vulnerable to rising spreads, but is better placed in relation to HY.

Corporate defaults are on the rise



Source: Bloomberg

The light on equities is dimming

Equity markets have performed much better than we expected, with a continuation of the rally that started back in Q4 2022. Many markets are up more than 20% since their lows of last year, the common definition of a bull-market, and momentum has been strong. While earnings have fallen and margins squeezed, this has proven to be less severe than expected. Investors have also been prepared to look through the much touted economic slowdown and inverted yield curve, and have embraced a soft economic landing as their narrative, lifting stocks to 12-month highs.

While rising rates typically reduce stock multiples, as discount rates for future dividend streams rise, this has not been the case this year, with multiples actually rising modestly to inflated levels. Indeed, with cash rates offering investors risk free returns of around 5% in the case of both the US and UK, equities have a new competitor in their midst. In addition, short positioning has now been rebalanced and sentiment has improved, while earnings and margin expectations seem to us to be overly optimistic given the macro backdrop.

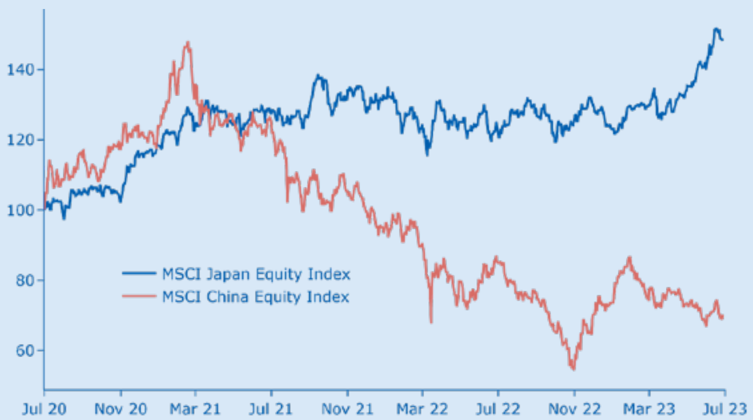
Earnings under pressure as financing tightens

Source: Bloomberg

The surprise going forward, we suspect, could be the pace of earnings downgrades in many developed markets. Companies have been able to push price increases through in the midst of high inflation, but this appears to becoming more difficult, particularly as there has been more focus on 'greedflation' - pricing above input cost rises. Within equity markets, Chinese stocks have substantially underperformed over the past two years and should benefit from additional stimulus and even a modest warming in terms of investor sentiment.

Japan has been a stellar performer this year, with some justification given the weak yen and improving capital management and profitability of the corporate sector. Although looking stretched in the short run, foreign investor flows have likely further to run. That noted, equities in general remain vulnerable and should be treated with caution, as there is room for substantial downside if indeed recession beckons and earnings shrink as we expect.

A tale of two countries as investors exit China and embrace Japan



Source: Bloomberg Rebased to 100, Jan 1st 2023

Conclusion

Robust labour markets and the remnants of excess savings have generated better than expected growth and supported gains in the equity and credit markets. There is increasing evidence, however, that this is changing, The penal rise in interest rates to tame inflation is now inflicting wounds on the global economy. While some emerging markets are in good shape and can act as a counterbalance, recession in the US and Europe, along with weakening elsewhere, will push global growth well below trend, as central banks find it hard to thread the needle of balancing growth and inflation. Consequently, risk assets are vulnerable as investor enthusiasm abates, earnings fall and margins decline.

Looking further out, this is not expected to be a deep or prolonged recession as experienced in 2008 or during the pandemic. Excesses are less prevalent and warning signals have been visible for some time. It will still be painful and disruptive, however, and policy support is likely to be less forceful given lingering inflation fears and the unintended consequences of prior support measures.

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