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Our outlook seeks to assess the balance of economic and geopolitical risks against a backdrop of elevated global inflation and diverging monetary policy.

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The remainder of 2022 is likely to bring a substantial slowdown in growth for major developed economies.

A significant monetary policy pivot

In stark contrast with the end of 2021, expectations for monetary policy have evolved to indicate a rapid pace of tightening across the Fed, Bank of England, and even some expectation of European Central Bank tightening.

Every six or so months, we bring together some of the key investment professionals and thought leaders at Invesco to formulate our outlook. This is always a very collaborative effort, pulling together thought leaders and investment professionals from all over Invesco.

I think it's worth noting that we create a framework, as opposed to a specific outlook. With a framework, we can provide a macro scenario that we believe is most likely — what we call our 'base case' — but also offer two other alternate scenarios that clients might anticipate, along with asset implications in the event either one of the scenarios comes to fruition.

Let me begin by stating the obvious: much of the world continues to move past the COVID-19 pandemic, but its remarkable effects on economies and policies remain top of mind as a new set of uncertainties enters the picture.

Historic pandemic-era moves by both fiscal and monetary policymakers had already reawakened inflation after a multi-decade slumber in most economies, which was then compounded by Russia's invasion of Ukraine. The war exacerbated inflationary pressures while also exerting downward pressure on economic growth through a surge in commodity/energy prices.

Markets are contending with all this just as many major central banks are tightening policy — some rather aggressively. Our Mid-Year Outlook seeks to assess the balance of economic and geopolitical risks against a backdrop of elevated global inflation and diverging monetary policy.

Where are we in the cycle?

While pandemic-driven factors continue to complicate cycle analysis, we nevertheless see higher inflation and slowing growth, indicating that we may be late in the business cycle. The remainder of 2022 is likely to bring a substantial slowdown in growth for major developed economies.

Major Western central banks such as the US Federal Reserve (Fed) are attempting a delicate balancing act, trying to tighten monetary policy enough to cool the economy and lower inflation, but not tightening so much as to send their respective economies into recession. This task is admittedly growing increasingly difficult.

What's the direction of economies?

Following large fiscal stimulus programs and very accommodative monetary policy, we see economies continuing to slow from their elevated post-pandemic growth rates with key challenges ahead.

We see Western developed economies benefiting from a post-Omicron reopening in the second half of 2022. This should help provide at least some counterbalance to economic headwinds in the

form of rising rates and an inflation-induced cooling of demand.

The eurozone and UK are both challenged by higher energy prices and potentially curtailed supply. These effects are likely to be at their most significant in the middle of 2022 as markets assess geopolitical risk premia.

Canada's economy has fared better than other Western developed economies, benefiting from higher energy and commodity prices, but is also expected to slow as the Bank of Canada tightens monetary policy.

Chinese growth is in what we see as a temporary slowdown, driven largely by COVID-19 related factors. However, we expect an economic reacceleration to begin in the back half of 2022, driven by monetary and fiscal stimulus, and a return to potential thereafter.

Inflation expectations are up but concentrated in the near term

Currently, inflation is well above the Fed's 'comfort zone,' and shorter-term inflation expectations are high for the US, UK, Canada, and the eurozone. However, longer-term inflation expectations appear better anchored.

A historical perspective is also encouraging. US Inflation expectations ahead of the 1980 and 1991 recessions were very elevated for both the one-year ahead and 5-10 year ahead periods.¹ That is not the case now, as longer-term inflation expectations are significantly lower than short-term inflation expectations.

A significant monetary policy pivot

In stark contrast with the end of 2021, expectations for monetary policy have evolved to indicate a rapid pace of tightening for major Western developed central banks, although the degree of tightening that is possible is dictated at least partially by the health of the underlying economy.

We have already seen a very significant tightening of financial conditions for many Western developed economies, as money supply growth has slowed. For example, in the United States, mortgage rates have risen by more than 200 basis points since the start of the year.²

Despite various global growth headwinds, policymakers are nevertheless focused on addressing inflation. For the Fed, we see a tightening cycle in line with market pricing. As a result, we expect the entire yield curve to flatten by year end. We have already seen a significant tightening of financial conditions and a loss of spending power in some major developed economies that should help to cool demand.

Western developed economies in deceleration

Most Western developed economies are already showing signs of a substantial slowdown. For example, the Purchasing Managers' Index (PMI) for both the US and eurozone experienced notable declines from May to June. We believe the odds of a recession are higher in the eurozone than the US, given high energy prices that are more difficult to control with monetary policy.

While more aggressive tightening increases the odds of a recession in the US, we still believe the Fed has the potential to execute a 'soft landing.' Factors that should help include a tight labor market, with a high level of job openings that can be cut in lieu of some layoffs, as well as the Fed's commitment to be data dependent.

China's growth likely to reaccelerate in second half of 2022

COVID-related lockdowns in China have brought with them renewed challenges for growth. While we have seen substantial economic headwinds in the first half of 2022, we expect a rebound in the second half of the year helped by a combination of fiscal and monetary policy stimulus. This is in contrast with many Western developed markets that are withdrawing stimulus.

Asset class implications

We believe a neutral risk stance relative to the benchmark is appropriate. Given that we anticipate a global slowdown, we expect modest positive returns with narrow dispersion in performance between fixed income and equities. In this environment, we prefer a slight overweight to equities relative to fixed income, with equity exposure tilted to defensive sectors, and quality and low volatility stocks. We favor the US over developed markets ex-US, but relatively equally weighted to both developed markets and emerging markets. Within fixed income, we prefer quality credit and are neutral on duration. Fixed rate investment grade and municipal bonds are specific areas of potential opportunity. Within alternatives, we prefer energy, value add real estate, and core plus infrastructure.

Alternate 'tail risk' scenarios

I also mentioned two alternate 'tail risk' scenarios, which I will briefly cover below:

1. Russian energy cut-off scenario

In this scenario, the world experiences an energy shock because of a Russian embargo or European boycott of energy trade, resulting in significantly higher inflation, especially in Europe. We assume this scenario would result in stagflation in Europe and bite into real incomes throughout the globe, resulting in overall lower global growth.

In terms of asset class implications, we would anticipate a 'risk off' environment and prefer an underweighting to risk assets relative to the benchmark. We would favor underweighting cyclical sectors except energy, given the greater negative impact to growth. We would prefer the US over developed markets ex-US, but we would favor developed markets over emerging markets. Despite higher inflation rates, this energy shock may have a negative impact on growth, which could limit the upside in bond yields. High quality credit could provide a relatively attractive investment in this scenario. In alternatives, we would prefer core real estate. In general, we would favor more liquid and more defensive parts of the market in this scenario.

2. Improved war outlook scenario

In this scenario, a surprise de-escalation of hostilities almost eliminates the risk of an embargo or boycott on Russian energy, in turn reducing the current geopolitical risk premium in energy prices and other key commodities. We would expect this scenario to yield overall higher growth, but it would expand the ability for central banks to tighten monetary policy globally because there would be less concern about plunging economies into recession.

In this scenario, we would prefer an overweighting of risk assets relative to the benchmark. We would expect a reacceleration in growth to result in higher bond yields, and we would prefer riskier and shorter duration credit. In alternatives, we would prefer riskier sub-asset classes such as leveraged buyouts. In general, we would prefer riskier parts of the market in this scenario.

With contributions from Rob Waldner, Chief Strategist and Head of Macro Research, Invesco Fixed Income, and Alessio de Longis, Senior Portfolio Manager and Head of Global Tactical Asset Allocation Solutions

Notes

¹Source: University of Michigan Surveys of Consumers

²Source: Today's Mortgage Rates & Trends – June 15, 2022: Rates continue to surge

Important information

Header image: Westend61 / Getty Images

A defensive stock/sector is a security/sector whose price isn't highly correlated with the larger economic cycle.

The European Central Bank (ECB) is responsible for the monetary policy of the European Union.

The Eurozone (also known as the euro area or euroland) is an economic and monetary union of 18 European Union member states that have adopted the euro (€) as their common currency.

A flat yield curve is one in which there is little difference in the yields for short-term and long-term bonds of the same credit quality. In a normal yield curve, longer-term bonds have a higher yield.

Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors.

A basis point is one hundredth of a percentage point.

A short-duration strategy is one where a fixed-income or bond investor is focused on buying bonds with a small duration. This usually means the investor is focused on bonds with a small amount of time to maturity.

A leveraged buyout (LBO) is the acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. The assets of the company being acquired are often used as collateral for the loans, along with the assets of the acquiring company.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Asset allocation does not guarantee a profit or eliminate the risk of loss.

Investments in real estate related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate. Real estate companies, including REITs or similar structures, tend to be small and mid-cap companies and their shares may be more volatile and less liquid.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

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