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# Higher inflation, recession more likely





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## Introduction

Late July news of the Federal Reserve (Fed) increasing interest rates another 0.75% and a second negative quarter of economic growth (GDP) create an uncertain environment for investors going forward. Adding to these concerns is China's economic slowdown and Europe's energy shock. In our mid-year Macro Perspectives, I explore with our economists whether a stagflation (inflation plus slowing growth) scenario can be avoided, and where investors might find opportunity—or at least temporary shelter.

Below are some key themes our economists are watching closely:

- **Painful US landing?:** June's annualized 9.1% US inflation print and the latest report of two quarters of negative economic growth have stirred the markets. The Fed wants to bolster its credibility as an inflation fighter perhaps more than its concern of causing a recession. If the Fed doesn't do enough, inflation might remain high—too much and the economy could move to recession, if it hasn't already. Higher prices to consumers increase the risk of further inflation and a wage-price spiral that ironically can cause additional inflation.
- **Shallow recession:** Forward-looking economic indicators tell us that inflation may have peaked. If this occurs and the Fed interprets the economic data effectively, it can avoid overshooting and increasing the risk of a major recession.
- **US dollar appreciates:** The strength of the US dollar since the Fed started hiking in mid-March has created additional commodity-related inflation for the economies in Europe, Japan and emerging markets. For now, this dynamic favors the United States because commodities are priced in dollars and imports are less expensive, which should help lower inflation.
- **Europe's energy shock:** A risk to consider is that Russia might cut off Europe's oil and gas supplies. This could send Europe into further inflation and a deeper recession in 2022, while also driving global energy prices higher. This would likely increase inflation in the United States and might cause the Fed to further increase interest rates.
- **China and COVID-19:** China's need to impose more lockdowns plus its struggling property sector could mean slower global growth this year.

The outlook for the rest of the year is complicated. And yet, this environment is also creating dislocations that provide investment opportunities across capital markets. Globally, sovereign bond yields have drifted upwards toward pre-pandemic levels. Our investment teams see opportunity in corporate bonds across the credit and maturity spectrum that are starting to yield more than corresponding equity dividend yields. There are also opportunities in emerging market debt.

I hope the discussions in Macro Perspectives offer valuable insights as we navigate the second half of the year.

# Executive summary

The first half of 2022 was painful for investors. Large losses around the globe hit everything from stocks and corporate bonds to traditionally staid sovereign bonds. Outside of private markets and commodities—which benefited from rising prices—the only safe haven was cash (but not on an after-inflation basis). Equity and bond markets were reacting to stubbornly high inflation, alongside increasing risks of recession in the face of interest-rate hikes.

Of course, the world's major central banks are raising rates primarily to tame inflation, while trying not to throw their economies into recession. This July, the European Central Bank (ECB) kicked off its first rate hike of 50 basis points (bps),<sup>1</sup> while the US Federal Reserve (Fed) made its fourth hike of 2022 at 75 bps. Some of our economists believe the Fed was too slow to respond to the threat of inflation. First, by misjudging inflation as transitory in 2021; then, by extending quantitative easing (QE) into 2022 long after the US economy had staged a post-lockdown recovery.

Given this backdrop, market sentiment has shifted noticeably since we met with our panel in April. Inflation remains a key factor, but the dominant concern is now for recessions in the United States, Europe and perhaps globally. Indeed, the US economy shrank in the second quarter (2Q), based on initial estimates—a second estimate using more complete data comes in August, while the final 2Q gross domestic product (GDP) arrives in late September.<sup>2</sup> Although not officially a recession—see “defining recession” further below—most of our economists think the risks of a US recession in 2023 are quite high.

In the meantime, soaring inflation and rate hikes have driven multiples<sup>3</sup> on equities and fixed income values lower, while the specter of recession hammers profits/earnings expectations for both equity and corporate debt. Complicating our outlook for the second half of 2022 are several wildcards—see Wildcards on page 6—that may trigger more market disruptions. If Russia cuts Europe off from oil and gas, for example, the impact on US and global inflation could far outweigh the Fed's next rate hike decision in September. China's policy-driven slowdown is another key concern. If the spread of coronavirus picks up again, a return of zero-COVID lockdowns could wreak havoc on Chinese manufacturing and shipping.

There's also the relentless strength of the US dollar to consider. While it makes imports into the US cheaper, a strong dollar tends to inflict pain on the rest of the world. Europe has been struggling under the weight of higher commodity prices, which often trade in the dollar. With the euro recently dropping to parity with the dollar for the first time in 20 years, those commodities are now even costlier for Germany.

## Peak inflation or false hope?

In early July, several forward-looking economic indicators appeared to signal that US inflation might be peaking. Big US retailers, for example, are sitting on piles of unsold inventory. Western Asset Portfolio Manager John Bellows explained how rising inventories and slowing sales are typically signs of a cooling economy. It also points to more price reductions, as retailers need to mark down goods to clear inventory. That's a big shift from 2021 when supply chain disruptions crashed into record demand, driving prices sky-high.

On the global stage, classic supply-driven inflation—“cost-push” inflation from rising raw material prices—also shows signs of abating. For starters, there's been a welcome decline in key commodity prices, as shown below in Exhibit 1.

## Commodities Go on Sale

Exhibit 1: Brent Crude, S&P GSCI Agriculture Index and S&P GSCI Industrial Metal Index (Prices in \$US)

January 1, 2022–August 1, 2022



Sources: Bloomberg, S&P Dow Jones Indices. Past performance is not indicative of future performance.

Given falling demand from China's slowdown, red-hot metal prices, like copper, have cooled somewhat. Prices for oil and agricultural commodities such as wheat, corn and soy are also coming down. Shipping, whether it's trucking or ocean freight, is also seeing price declines. These are all good indicators of a potential shift away from peak inflation.

The feelings of optimism were negatively impacted by June's headline Consumer Price Index (CPI), which came in at a surprisingly high 9.1% increase versus June 2021. Sometimes we can dig deeper to uncover some underlying coolness in inflation data—but not this time. Both headline and core inflation were unambiguously impacted by a broad-based increase in prices. From a price pressure perspective, the June inflation metrics are surprising—though not to Franklin Templeton Fixed Income Chief Investment Officer Sonal Desai. She's long argued that letting inflation run amok could snowball into something worse. And indeed, that's exactly what new data are showing.

The Atlanta Fed publishes indexes that divide inflation into "flexible" versus "sticky" prices that historically change relatively slowly. As outlined below in Exhibit 2, sticky inflation is now finding its way into more prices in the US economy, noticeably rising over the last three months and running at an annualized rate of 8.1%, the highest in four decades. This is exactly what the Fed doesn't want to see.

### Sticky Prices Surge

#### Exhibit 2: Atlanta Fed Sticky-Price CPI—Not Seasonally Adjusted (NSA)

June 30, 1982–June 30, 2022

3-months Annualized Growth Rate



Sources: Bloomberg, Federal Reserve Bank of Atlanta.

### Across the spectrum

We've picked the previous two exhibits as illustrative bookends—one optimistic the other more dire—to help characterize the spectrum of opinions from our five economists on the current risk of a US recession. Within the group, John Bellows is the most optimistic about the Fed's ability to tackle inflation, while still avoiding an outright recession in 2023. John expects inflation to moderate in the second half of 2022, as it does not typically survive in an environment of decelerating money supply, tightening financial conditions, and survey and market-based inflation moving lower.

At the other end of the spectrum, the rise of stickier prices creates an environment that's ripe for a wage-price spiral to emerge, in Sonal's view. Not only are firms more likely to offer raises to keep up with cost-of-living adjustments, they may pass on those labor costs to consumers via higher prices.

Sonal's other concern is a potential regime shift in expectations, driven by the Fed's "reaction function"—the way it responds to inflation and unemployment. If businesses and consumers think Fed Chair Jerome Powell is overly concerned about preserving employment, the Fed could lose its credibility and trigger a self-fulfilling prophecy of accelerating inflation expectations. This combo of elevated inflation and slowing growth creates a much higher risk of recession in the second half of 2023. Sonal doesn't see a hard landing—yet—but she's concerned that if a recession comes while inflation is still elevated, it could create a stagflationary environment.

In between these two bookends of optimism and pessimism, Franklin Templeton Investment Solutions' Head of Research, Gene Podkaminer, Brandywine Global's Director of Global Macro Research Francis Scotland and Templeton Global Macro's Chief Investment Officer Michael Hasenstab all agree the risks of a shallow US recession in 2023 have increased. Gene thinks balance sheets for corporates and individuals are still strong—the labor market also remains healthy—reducing risks of a hard landing. Francis sees clear signs of an economic slowdown from declining disposable income, money growth contraction, and a global tightening of policies. Michael thinks that weak US manufacturing growth in the first half of 2022—driven by inventory drawdowns due to supply chain issues—could stabilize in the second half. Consumption is also shifting from goods to services where inflation is more "sticky." Both trends mean the Fed may need to keep rates higher for longer. In the coming months, there will be plenty of fresh economic data that might sharpen or change our economists' convictions.

## Defining recession

It's important to point out how our team defines recession. In the financial media, a recession is sometimes understood as when GDP contracts for two straight quarters. Indeed, that's already happened, with second quarter US GDP dropping an annualized 0.9% this year.<sup>4</sup> But that's not how we define the term, nor how the National Bureau of Economic Research (NBER) defines recessions in the US. For citizens in Europe and the United States, it may certainly feel like we're in a recession given sky-high prices for petrol and food. However, the hallmark of an official recession includes a significant decline in economic activity that spreads across the broad economy. Key factors include rising rates of unemployment—something we don't see yet in the United States—and declining industrial production. This recession scenario, however, looks increasingly likely in 2023 in the eyes of our economists.

## The mighty US dollar

Inflation in the United States isn't the only economic dynamic impacting our recession outlooks into 2023. The steep rise of the US dollar over the past year creates real problems for the rest of the world as most of the global trade is still US-dollar denominated. Why is this a problem? Well, the flipside of a strong US dollar is weaker foreign currencies like the euro and Japanese yen. Both have recently fallen

## The US Dollar Inflicts Pain

Exhibit 3: Global Goods Trade Fluctuates With the Strength of the US Dollar  
Q1 2000–Q1 2021



Source: Bruno, V. and Song Shin, H. "Dollars and exports: The effects of currency strength on international trade," VoxEU.org, July 27, 2021. "Federal Reserve Board trade-weighted nominal dollar index, broad group of major trading partners of the US based on trade in goods and services. An increase indicates appreciation of the US dollar. \*\*Both exports and GDP are measured in constant prices. Data sources: Federal Reserve Bank of St Louis, FRED; IMF, World Economic Outlook; World Trade Organization; Datastream; BIS calculations.

dramatically, relative to the dollar, to levels not seen in two decades. That means buying foreign goods, especially commodities, is now more expensive for Germany and Japan.

Recent currency research shows when the US dollar is weak, global trade is strong; but, trade suffers when the dollar gains strength as shown below in Exhibit 3.<sup>5</sup> Some call this the "dollar doom loop." When the dollar strengthens, it can drag down global economic activity, which causes people to worry, which leads to a stronger dollar, and so on. We think this is a good backdrop for framing two more of our economists' wildcards—Europe's energy shock and China's zero-COVID policy and economic slowdown.

## The European perspective

At first glance, European inflation might look identical to US inflation. However, as Francis notes, Europe's underlying inflation drivers are largely driven by energy, commodity and food prices, whereas US inflation has been largely driven by overly stimulated consumer demand.<sup>6</sup> If there's a consensus opinion among our economists, it's that the risks of a European recession are much higher compared to the United States.

In particular, Russian President Vladimir Putin could cut off oil and gas supplies to Europe, plunging Europe into a recession this year. This isn't something the ECB can resolve with rate hikes and quantitative tightening, which just slows

the economy without addressing the causes of higher prices. Indeed, the European Union's (EU's) executive branch has announced that member countries must now cut natural gas consumption by 15% to stave off a crisis.<sup>7</sup> In terms of a slowdown, Francis thinks Europe's recession might already be here. In a future global recovery post-recession, he also thinks Europe will likely lag and not lead economic peers like the United States.

### China's slowdown

Gene recognizes that China's growth rate has enormous implications for the global economy and impacts "literally everything," much like the United States. For example, emerging economies like Brazil and Chile could face headwinds from commodity exports, which hinge partly on vibrant China growth. For Gene and most of our economists, China's zero-COVID policy remains the most unpredictable and inscrutable of wildcards, at least until the Communist Party conference later this fall. Regions in China that account

for about a quarter of the country's GDP were under some form of lockdown or heightened control this year.<sup>8</sup> Those lockdowns helped contribute to China's dismal 2Q GDP performance of 0.4%.<sup>9</sup> Median street estimates for China's full-year growth are now 3.4%.<sup>10</sup>

### What does this all mean for investors?

Today's inflation and growth picture concern us at a global level. With a lack of clarity on the economic front, capital markets are also cloudy, seemingly pricing in both high inflation and decelerating growth. And yet, this environment also creates dislocations that provide wider dispersions of investment opportunities across capital markets. Globally, sovereign bond yields have drifted upwards toward pre-pandemic levels. Corporate bonds across the credit and maturity spectrum are starting to yield more than their corresponding equity dividend yields. In addition, as the US dollar has become the haven of choice, there may be a future benefit to holding assets in select regions that are denominated in local currencies.

## Wildcards—worries and optimism

Here are some key themes our economists are watching closely

### Painful US landing

June's annualized 9.1% US inflation print was a rude awakening. We believe conditions are ripe for a wage-price spiral and more inflation. This scenario may require Volcker-like<sup>11</sup> rate hikes and pain for the labor market.

### Shallow recession

Forward-looking economic indicators tell us disinflation is taking hold. If the Fed lets data drive its decisions, we believe it can avoid overshooting and manage a shallow US recession sometime in 2023.

### US dollar doom loop

The strong US dollar is a drag on Europe's growth and emerging markets that transact in dollar-denominated commodities and global trade. For now, this dynamic favors the US.

### Europe's energy shock

Russia might cut off Europe's oil and gas supplies. This could send Europe into recession in 2022, while also driving global energy prices higher and scrambling the US Fed's trajectory.

### Zero-COVID

China's willingness to impose more lockdowns—plus its struggling property sector—could mean slower global growth this year. One upside: lower prices for key metals and minerals.

# Regional lens: United States

## Economic whiplash

To understand where the US economy is headed, Francis Scotland re-introduced his concept of economic whiplash that he discussed with us in April. We think it's a compelling framework, and not only because it unfolded just as Francis predicted. It also dovetails in some ways with John's views, and in other ways with the views of Sonal. We explore that further below.

To set the stage, Francis brought us back to three macroeconomic anomalies from 2021, which he believed would revert this year. First, there was last year's phenomenal economic growth. Second, aggressive Federal policy support occurred alongside surging growth and continued throughout the boom. Indeed, the Fed's quantitative easing didn't stop until April of 2022. Third, was the steady rise of inflation.

By contrast, today we're seeing a significant slowdown in growth—a whiplash-like downturn compared to 2021. Why the drop? It's partly due to the Fed's dramatic 180-degree policy shift. This past March, the Federal Open Markets Committee (FOMC) officially ended quantitative easing, while also kicking off the Fed's first of four rate hikes as of this publication. From today's vantage point, Francis now believes the inflation pulse has peaked and should meaningfully decline into 2023. He also thinks economic indicators now point to a shallow recession in 2023.

### Three macroeconomic anomalies

#### 2021

1. Exceptionally strong economic growth
2. Stimulative Fed policy throughout the boom
3. Inflation steadily heats up

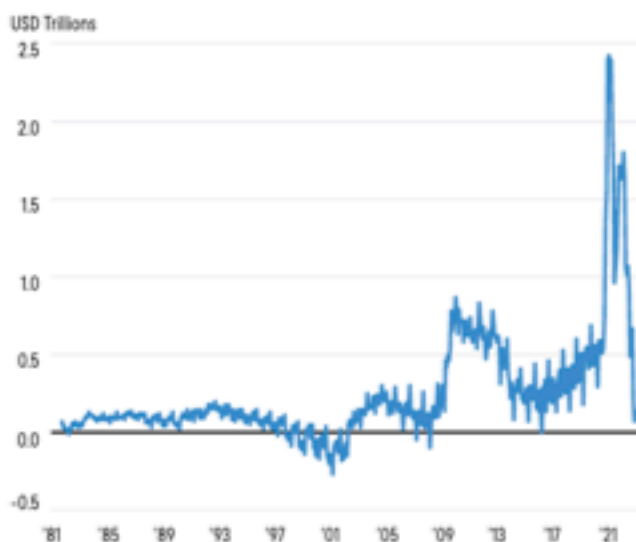
#### 2022

1. Striking growth slowdown relative to 2021
2. Dramatic policy pivot toward tightening
3. Inflation pulse peaks and begins its descent

At a broad level, John paints a similar big picture view, starting with the remarkable US growth of 2020 and 2021. Like Francis, John credits this growth to the US Federal Government's extraordinary policy support, both fiscal and monetary. John notes that most of this policy support unwound in 2022 at an incredible pace. Exhibit 4 and Exhibit 5 illustrate this big pivot, leading to what Francis calls economic whiplash.

## Fiscal Stimulus Reversal

**Exhibit 4: US Federal Government Outlays Minus Receipts**  
March 31, 1981–June 30, 2022



Sources: FactSet, US Department of Treasury.

## Money Supply Flatlines

**Exhibit 5: Growth in US Money Supply (M2)**  
March 31, 1981–May 31, 2022



Sources: FactSet, Federal Reserve Systems.

Over the last six months, the US Federal Government has run a balanced budget. This is a big change, and not just from the previous two years. John reminds us that the United States hasn't run a balanced budget—where revenues equal fiscal outlays—in two decades.<sup>13</sup> On the monetary side, M2<sup>13</sup> growth—representing standard money supply—has been flat for the last three months. Outside of a crisis, the United States hasn't seen flat M2 growth in over thirty years.<sup>14</sup> So today we have both tight fiscal and tight monetary policy. How tight? The United States hasn't simply reversed to conditions prior to the COVID-19 pandemic. The United States now has tighter fiscal and monetary policy than anything seen in recent decades.

Given these conditions, John believes the US growth seen in 2021 is very much over. As stock investors may recall, last year's stellar economy helped drive market expectations, boosting equity markets to record highs. In stark contrast, we now have negative growth in this year's first half, with markets estimating a roughly 2% US growth rate for 2022.<sup>15</sup>

### No pain, no gain

If there's a key difference in outlooks between John and Francis, it's the concept of painful economic whiplash. The Fed currently anticipates it will be necessary to raise the federal funds rate (funds rate) to 400 bps over the next six to nine months. At that level, the funds rate would be 150 bps higher than it was pre-pandemic. In a soft-landing scenario, however, such a sharp increase in rates may not be necessary. John points to early signs of disinflation, which we turn to next, which are now visible to the naked eye. Should these early signs of disinflation gain traction over the coming months, both the Fed and the economy may end up with a more moderate outcome than is currently feared.

By contrast, Francis agrees with Sonal that the Fed misjudged inflation as transitory in 2021 and was fixated on labor participation. This dogmatism meant continuing QE long after the economy was already hot. Looking ahead, however, Francis worries the Fed might overdo rate hikes—potentially overshooting—to regain credibility, despite disinflation picking up. In his view, the Fed appears as dogmatic about tighter monetary conditions as it was convinced of the opposite last year. Francis thinks economic pain is coming in the form of a shallow recession in 2023.

Where Sonal parts ways with Francis and John is over Fed tightening. Sonal notes the spread of sticky inflation offers fertile ground for a wage-price spiral (i.e., runaway price inflation). Her preferred playbook comes from the Volcker era

**“There's a lot riding on the Fed's next moves, in our view. The clash of optimistic versus pessimistic views we've described here is quite likely playing out between members of the FOMC. While their debates are harder to decipher, we think its better to lay them out in the open.”**

when aggressive Fed rate hikes crushed inflation and restored order. In Sonal's view, a funds rate of 400 bps may not be enough to stamp out inflation.

There's a lot riding on the Fed's next moves, in our view. The clash of optimistic versus pessimistic views we've described here is quite likely playing out between members of the FOMC. While their debates are harder to decipher, we think its better to lay them out in the open. To make each of their cases, our economists marshal sets of economic data to prove their points. Let's examine some of that data.

### Signs of disinflation

As we highlighted in our executive summary, there's an array of forward-looking indicators that tell Francis and John that the inflation pulse has peaked, and should decline incrementally as we head into 2023. As we previously showed in Exhibit 1, the notable pattern of falling commodity prices—whether due to increased supply or lower commodity demand from China—reinforces Gene's view that inflation is likely moderating, albeit still in early stages. These commodities—oil, industrial metals, food staples—are key ingredients of production, so when they get cheaper it means production costs go down. Gene also points to major US retailers, who are slashing prices to clear out inventory. You don't need to be an economist to notice significant price drops for durable goods when shopping online.

### Housing prices

The US housing market is another point of debate among our economists. John points to the sharp decline in new-home sales, together with much lower levels of applications for mortgages. In John's view, today's combo of high housing prices and elevated mortgage rates will likely dampen further price increases. Why will this happen? Simply put, the current macro environment—tight fiscal and monetary policy, combined with zero growth—is a 180-degree pivot from the



macro environment of the past two years. It's unrealistic to expect the housing market to remain immune to cooling given the tightness of our current macro environment.

Sonal doesn't dismiss this macro shift. Rather, she points to the historically strong connection between wages and housing costs. As shown in Exhibit 6, rents as measured by CPI—which are based on what tenants currently pay rather than market prices for vacant units—are accelerating in line with the most reliable (but lagged) measures of wage growth. As shelter accounts for a third of the total CPI, this is a serious problem. It's hard to see how tighter monetary policy can offset escalating rents. At these levels, Sonal thinks sky-high rents offer fertile conditions for a potential wage-price spiral.

### Wage growth

The economic dynamics of a wage-price spiral are fairly straightforward—it's what might happen if higher rents and consumer prices encourage workers to bargain for a pay raise. Higher wages increase corporate costs, which could force companies to raise prices, and so forth. Thus far, real wage growth isn't spiraling up—in fact, it has tapered off as shown in Exhibit 7. However, that doesn't mean we can rule it out. After all, inflation is still going strong according to the June CPI numbers. The longer inflation sticks around, we may see an uptick of inflation expectations among households, which then demand higher wages.<sup>16</sup>

### The Volcker era

It's not outside the realm of possibility that current opinions—both pessimistic and optimistic—might shift based on concrete new data. For now, Sonal is the most hawkish over inflation. She knows markets are historically bad at predicting future inflation. Better to err on the side of caution. But does this require a strong Volcker-like response? Paul Volcker, who took over the Fed in the early 1980s, crushed runaway inflation by raising interest rates all the way to 19%. It was enough to cause a deep—but short—recession. Something to keep in mind as we look forward to the July CPI report that arrives in August.

### Rent Inflation Hits 36-Year High

Exhibit 6: US CPI Urban Consumers Rent of Primary Residences September 30, 1982–June 30, 2022



Sources: Bloomberg, Bureau of Labor Statistics.

### Wage Growth Decelerating

Exhibit 7: Average Hourly US Earnings: Total Private Industries December 31, 1982–June 30, 2022



Sources: FactSet, US Department of Labor.

# Regional lens: Europe

## External shock

The current macro outlook for Europe is grim, to be blunt. The risks of recession are high, if one is not already here, according to Francis. But it's worse than that. To start, the political crisis in Italy has intensified the risks of fragmentation across the EU. All of these risks exist against a backdrop of a severe energy shock and war-time rationing of natural gas. We are rooting for Christine Lagarde, president of the ECB. She faces a daunting challenge in the months (and years) ahead.

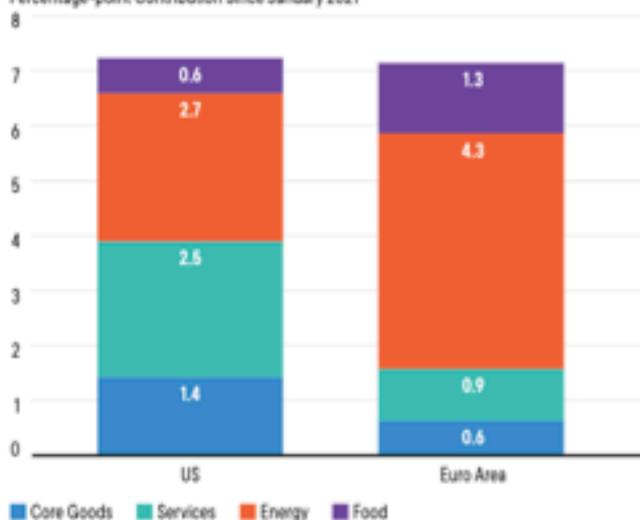
Let's start with inflation, the main driver of recession fears. On the surface, European and US inflation look the same. But underneath, Gene notes Europe's inflation is driven mostly by an energy shock triggered by Russia's invasion of Ukraine, as shown below in Exhibit 8. In the United States, household demand—chiefly for goods and services—plays a much larger role. That type of inflation can be fixed with rate hikes that cool demand. Europe's inflation is a different animal, caused by an external shock. Namely, Russian gas that Francis believes Russian President Vladimir Putin is using as a weapon. Raising rates by 50 bps this July, the EU's first hike in 11 years, doesn't address this shock. Lagarde and the EU now

## US vs. Europe Inflation Drivers

Exhibit 8: Change in United States and Europe Inflation Across Four Sectors

January 2021–June 30, 2022

Percentage-point Contribution Since January 2021



Sources: Bloomberg Economics based on Bureau of Labor Statistics and Eurostat.

face a terrible situation: inflation that's high enough to require monetary tightening, and an economy barely strong enough to need cooling.

## War-time rationing

Europe's largest economy, Germany, is on the precipice of a contraction that's directly tied to Russia. The International Monetary Fund warns that Germany's economy risks losing 4.8% of economic output if Russia shuts down supplies of natural gas to the country.<sup>17</sup> With natural gas prices surging on the news, it's a tense and volatile situation in Germany. In a defensive move, the European Commission asked all member countries to reduce natural gas use by 15% to prepare for a potential cutoff from Russia. In response, Spain and Portugal say they aren't onboard. Both will defend European values but won't accept this sacrifice because their energy systems aren't linked with Europe.<sup>18</sup> For Sonal, this reaction points to a bigger problem for Lagarde and the ECB. Namely the fragmentation between Europe's fiscally prudent northern countries, like Germany, and southern debt-laden neighbors like Italy.

## Fiscal fragmentation

One demonstration of Europe's quagmire is the widening spread between the yields on German and Italian sovereign bonds. The more aggressively the ECB chooses to hike, the greater the concern over Italy's shaky economy grows, driving Italy's yields even higher. Now add to this toxic dynamic the resignation of Italy's prime minister, Mario Draghi. This political shift amps up uncertainty for Italy, Europe's third largest economy. As a former ECB president, Draghi knows how to navigate EU disfunction. By contrast, the current favorite to replace Draghi is Giorgia Meloni. She leads a party directly descended from Benito Mussolini's fascist movement, called the Brothers for Italy. One potential reprieve comes from the ECB's new Transmission Protection Instrument (TPI), which allows it to buy Italy's bonds to drive yields lower. But there's vagueness about how the TPI works. The ECB press release simply states it can buy securities "to counter unwarranted, disorderly market dynamics."<sup>19</sup> Who decides what's warranted—fiscally austere countries like Germany? For Sonal and Francis, this scenario has clear echoes of the EU's sovereign debt crisis a decade ago. This will be a hot European summer, in more ways than one.

# Regional lens: China

## Policy-driven slowdown

China's economic slowdown might seem dramatic at first glance. GDP rose a mere 0.4% in the second quarter, missing consensus forecasts of 1.2% by a wide margin.<sup>20</sup> Can China still reach its official annual GDP target of 5.5% in 2022? John doesn't think so, noting his team now expects 4% growth for 2022. Some street estimates go even lower. Michael, however, is less pessimistic about China's growth outlook.

To start, China has shifted to more domestic demand-led growth in recent years rather than relying on exports. Looking closely at Exhibit 9, you see retail sales and industrial output are picking up again—early signs of improvement. If needed, China also has the means to boost specific sectors of the economy with targeted fiscal stimulus. China's growth also benefits from the world's largest free trade agreement—the Regional Comprehensive Economic Partnership of 15 Asia-Pacific countries including China—that strengthens China's regional trade partnerships. For all these reasons, Michael isn't expecting a hard landing for China this year or in 2023.

## China Slowdown

Exhibit 9: China Economic Activity  
Q4 2018–Q2 2022



Sources: FactSet, National Bureau of Statistics China.

## Mortgage boycotts

This slowdown comes on the heels of two policy initiatives that rattled consumer confidence. The first involves the property sector, which Sonal's team reported on last summer.<sup>21</sup> In a nutshell, China initiated a series of rules that aim to curb real estate developers' addiction to debt. A year later, many developers are still struggling—it's not uncommon to see half-built projects stuck in limbo, as developers work out debt restructurings.

Likely more concerning is the fact that thousands of homeowners are withholding mortgage payments on unfinished apartments. To avoid a spread of mortgage boycotts, policymakers are acting. Financial regulators are urging banks to boost lending to builders to help finish projects and are considering giving homeowners a grace period on payments.<sup>22</sup> China policymakers are also accelerating the deployment of bank loans to local authorities for infrastructure projects. Building is a tried-and-true strategy for boosting economic activity.

## Lockdown fatigue

The second policy that weighs on consumer confidence is zero-COVID, China's strategy for halting the spread of the coronavirus. Harsh lockdowns contributed to a dramatic decline in economic activity. Today, with the BA.5 variant spreading, close to 30 million people are under forms of movement restrictions.<sup>23</sup> However, Michael points out that authorities see the impact that unyielding zero-COVID policies have had on consumer sentiment, as shown in Exhibit 10 on the next page. He believes a course correction is underway to achieve a better balance between controlling the spread of COVID-19 and supporting domestic growth. Future restrictions will likely have less of a negative impact on China's growth.

## Opportunities beyond China

For all the handwringing over China's slowdown, Michael sees attractive investment opportunities in the wake of this year's indiscriminate selloff among emerging markets. Some of the key economic attributes he looks for are strong social cohesion and good fiscal governance, lower needs for external financing and central banks that earned

## Consumer Outlook Nosedives

**Exhibit 10: China Consumer Confidence**  
December 30, 2005–May 31, 2022



Sources: FactSet, OECD.

credibility by tackling inflation much earlier than the Fed. On a regional basis, Asia stands out positively from the emerging-market pack.

South Korea's central bank, for example, was one of the first Asian central banks to hike interest rates in August 2021.<sup>24</sup> South Korea's supply chain linkages with China also stand to benefit from China's borders reopening. Michael also favors Indonesia, which is blessed with natural resources with high global demand—namely 60%<sup>25</sup> of the world's palm oil supply alongside coal, natural gas and mineral ores, like copper and nickel. Indonesia is also taking a disciplined approach to reducing its fiscal deficit. Thanks to elevated commodity prices, Michael's team expects Indonesia will meet its budget deficit target of below 3% of GDP in 2023.

Beyond Asia, Michael believes Latin America offers some attractive risk-adjusted opportunities. Chile, for example, has relatively low debt financing needs and a credible central bank that recently committed US\$25 billion of its international reserves to support its currency over the next three months. For all the uncertainty over inflation and a global recession, we believe the world still offers opportunities for managers with deep expertise in assessing macroeconomic fundamentals across emerging economies.

## Endnotes

1. One basis point equals 0.01%.
2. Source: Bureau of Economic Analysis, "Gross Domestic Product, Second Quarter 2022 (Advanced Estimate)," July 28, 2022.
3. A multiple measures some aspect of a company's financial well-being, usually by dividing one metric by another.
4. Source: Bloomberg News, "US Economy Shrinks for a Second Quarter, Fueling Recession Fears," July 28, 2022.
5. Source: Bruno, V. and Song Shin, H. "Dollars and exports: The effects of currency strength on international trade," VoxEU.org, July 27, 2021.
6. Source: Holland, B., Weber, A. and E. Curran. "The US Is Exporting Inflation, and the Fed Hikes Will Make It Worse," Bloomberg, July 18, 2022.
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