Twin Peaks

As we hit the midpoint of the year, the tempered optimism for the global economy that we had six months ago has been undermined by war in Europe and mass Covid-related lockdowns in China. Despite this, growth has been remarkably resilient, but so too has inflation, hitting 40-year highs in key regions and forcing a passionate resolve on the part of the central banks to bring it to heel.

Consumers, businesses, and investors alike are having to adapt to a changed landscape. Surging prices, rising interest rates and market volatility are proving persistent and unsettling, and financial assets have tumbled. The S&P 500 posted the second worst first half performance since 1932 and supposedly safe haven government bonds collapsed, with 10yr Treasuries providing the worst returns in over 200 years!

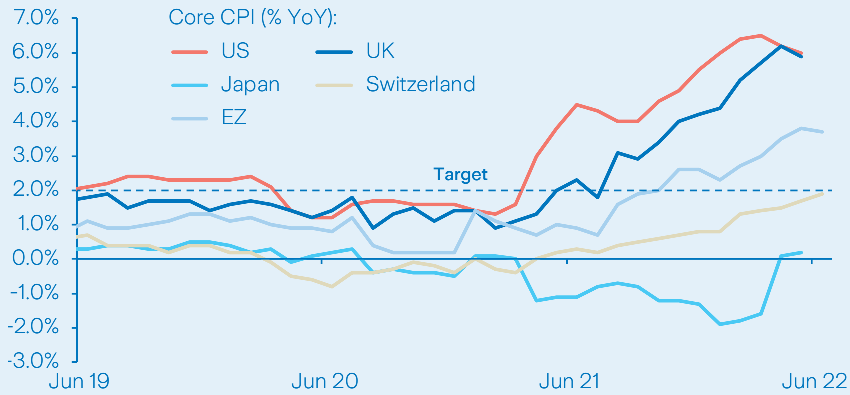
While we see the probability of recession as high, the economic and market outlook will be determined by the twin peaks of inflation and interest rates, both of which are coming into vision and offer some hope that any contraction will be mild.

One crisis after another

Just as the global economy was emerging from the pandemic, the horrors of war in Europe unleashed new forces that have undermined confidence and taken over the inflationary baton. Food and oil prices are up by more than 20% and 40% respectively since the start of the year, impacting the most vulnerable countries and societies globally, while natural gas prices in Europe are up by an astonishing 300% since last summer. Although there has been an appreciable fall in the inflation of many supply-constrained prices from the pandemic such as shipping, new and used cars, and semiconductors, the reality is that excess demand remains a critical driver of inflation, particularly now in services, with global growth still above trend, albeit slowing quickly. The policy initiatives during the Covid crisis have proven to be too generous in developed economies and while one must not ignore the counter-factual of what could have happened had the policy response not been so forceful in the midst of the worst contraction in over 100 years, the overspill is now troublesome, with inflation rife.

Inflation is running at a much higher level than we had anticipated and is taking longer to moderate, but we believe a peak is in sight.

Inflation remains disruptive, though a turn is in sight



Source: Bloomberg

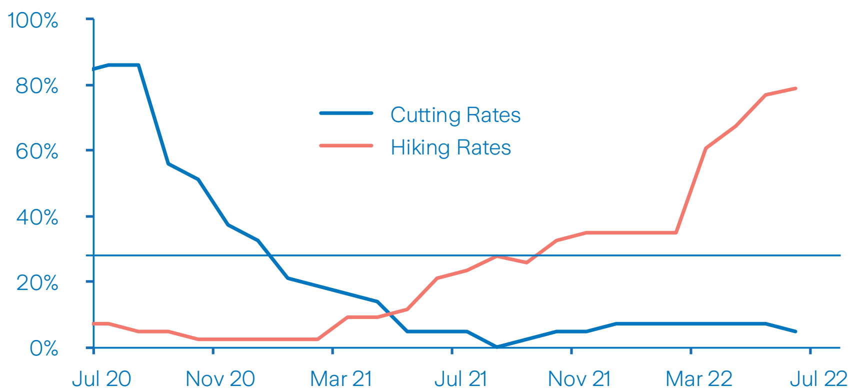
Too much stimulus has led to too much demand, driving inflation higher

Unemployment has fallen towards record lows in many parts of the world and household's excess cash positions in both the US and Europe, funded by generous fiscal programmes and curtailed spending at the height of the crisis, offer significant buying power. Following two lost summers in the northern hemisphere, pent-up demand for services is significant and driving up prices particularly in the leisure and entertainment sectors. However, while inflation is running at a much higher level than we had anticipated and is taking longer to moderate, we believe a peak is in sight. Goods prices that had been one of the largest drivers of inflation over the past 18 months are moderating as supply improves and demand shifts towards services. Supply bottlenecks have eased considerably, while lead times have declined and inventories have rebounded. It was telling that major US retailers Target and Walmart noted having excess inventories in their first quarter earnings reports.

Central banks take on a steely resolve to curb inflation

Central banks are making amends for their slow response to inflation and are now acting with force to honour their mandates. In the past three months 80% of the 43 central banks that we cover have raised rates, with the Swiss National Bank joining the chorus, hiking for the first time in 15 years. Indeed, not only is there a desire on the part of policymakers to slow growth, but also to boost their currencies to tame imported inflation. Clearly this is a zero-sum game. The Bank of Japan is the outlier in the current race to the top in rates. Despite the yen being at a 23-year low against the US dollar, and inflation now notably back in positive territory, policy has been kept unchanged. While the Bank of Japan remains on hold for the time being, there is no such reticence elsewhere despite growing signs that economic activity in developed regions is fading fast. Indeed, the Bank of England, in an unprecedented communication, forecasts a recession for the UK while continuing to hike rates. The US Federal Reserve (Fed) is increasingly accepting of the view that pain will be felt beyond simply removing the excesses in the system, as Chair Powell has made an "unconditional" commitment to price stability. Consequently, with central banks showing their independence in the trade-off between growth and inflation, we see a backstop in place that can avoid the turmoil of the inflationary era of the 1970s and there is evidence that market-based inflation expectations have started to turn lower as a result.

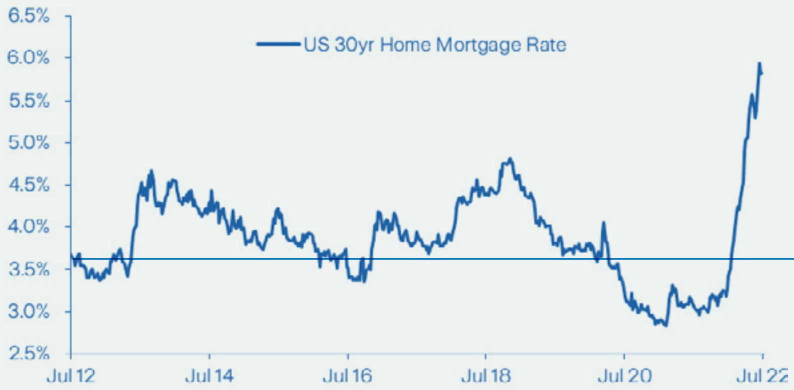
Central banks have raced to hike rates, but the pace will moderate



Source: Bloomberg, ZIG
Note: In a sample of 43 central banks from all regions.

Financial conditions have tightened significantly since the start of the year with US 30yr fixed rate mortgages doubling from 3% to 6% .

The cost of borrowing has jumped in many regions, which will slow demand



Source: Bloomberg

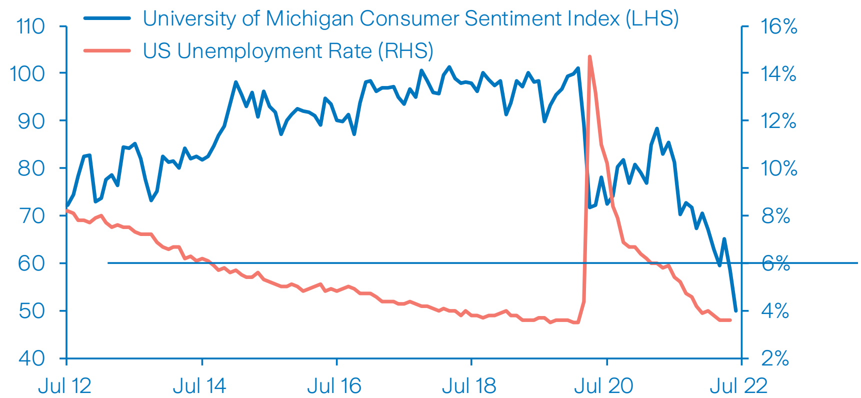
Growth is slowing and recession is likely

That noted, economic growth globally is slowing appreciably. While central banks deliberately let economies run hot following the pandemic, their initial largess has been countered by hawkish forward guidance resulting in financial markets responding quickly and doing a lot of the heavy lifting. Financial conditions have tightened significantly since the start of the year with US 30yr fixed rate mortgages doubling from 3% to 6% and credit spreads widening globally. The growth impulse was starting to slow naturally following the sharp rebound from the pandemic, but the potent combination of higher inflation squeezing real incomes, higher interest rates, less fiscal stimulus and much higher food and fuel costs are accelerating the slowdown in most regions. Unfortunately, we see a significant risk of recession, particularly in Europe and the US, which should ultimately cool the pace of rate tightening. China is in a different phase, with stimulus forthcoming and growth accelerating from depressed levels brought about by the Covid lockdowns. Consequently, the fortunes of the three largest economic blocks, the Eurozone, US and China will be critical to the macro backdrop that the rest of the world operates against.

The Fed walks a thin line

US growth surprised negatively in Q1, contracting by 1.6% QoQ annualised as further Covid disruption in services combined with strong imports. While we expect a rebound in Q2 and Q3, there is no doubt that the US economy is increasingly vulnerable. While financial markets have started to price in an imminent recession, we see this as more likely to take place in 2023. However, we expect the Fed to moderate its pace of hiking more than the market is currently pricing as growth slows and inflation eases back. Despite almost two job vacancies for every registered unemployed worker, and the unemployment rate falling to 3.6%, consumer sentiment is at a record low. While everyone who wants a job is likely to have one, real incomes are being squeezed and the jump in mortgage rates has put the brakes on the housing market. Spending has so far held up well as the savings rate has fallen to a 14-year low and US households still have excess cash to the tune of around USD 2.2tn, or about 10% of US GDP. This ability and current willingness to consume suggests to us that the real threat of recession is a little further out. Key signals to watch will be changes in the labour and housing markets.

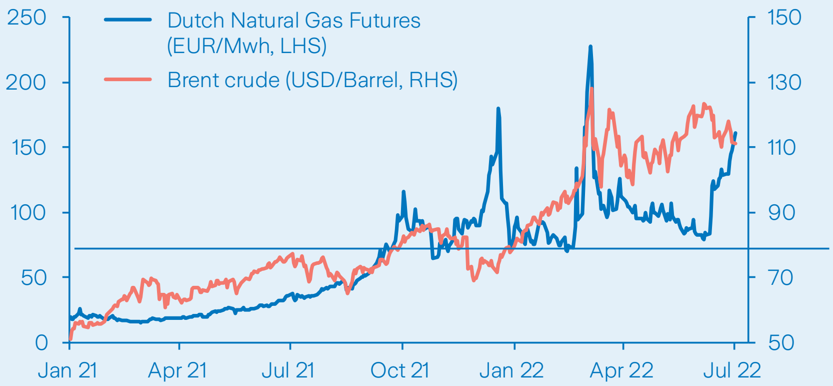
Despite very low unemployment, people are unhappy



Source: Bloomberg

The jump in energy and food costs are currently representing around 5 percentage points of the 8% rise in EZ headline inflation.

Energy prices are a major headwind, particularly for Europe



Source: Bloomberg

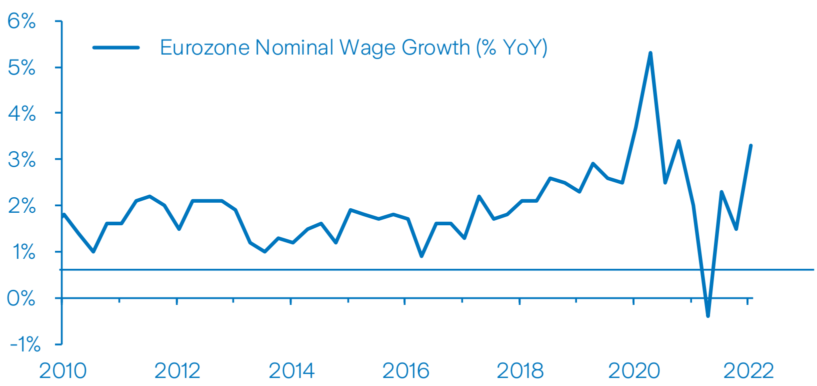
The Eurozone is at the mercy of Russian gas

Clearly the catastrophe of the war in Ukraine is casting a very dark shadow over Europe. While Eurozone prospects at the start of the year were particularly promising given the reopening of the economy, implementation of the NextGenEU funds, and a persistent improvement in the labour market, those fortunes swung dramatically around on February 24. The jump in energy and food costs currently represent around 5 percentage points of the 8% rise in EZ headline inflation. Reduced gas supplies from Russia in recent weeks will only exacerbate the move. Were disruptions to increase to the point of Russia suspending gas supplies at the onset of winter, for example, growth and inflation prospects would be dire. Fuel rationing is being prepared for, but this would undoubtedly push the region into a deep recession, affording Russia significant bargaining power. As it stands, our base case is less severe.

The summer sun masks underlying frustrations

The summer period still looks robust for the Eurozone, with hotels and travel operators reporting record bookings in a number of instances. As in the US, though to a lesser extent, households are still cash rich with an estimated EUR 500bn of excess savings, according to Barclay's, but underlying growth is in decline. Unemployment has reached record lows as we had expected, but with 8% headline inflation, real incomes are under tremendous pressure. Wage gains are still running at fairly modest levels, with unions and employers using one-off cash payments as temporary buffers, but pay demands are rising. The key will be how job security is weighed against wage demands as we head towards recession. We do expect higher wage increases in the second half of the year but expect them to be reasonable and in keeping with the ECB's inflation goals.

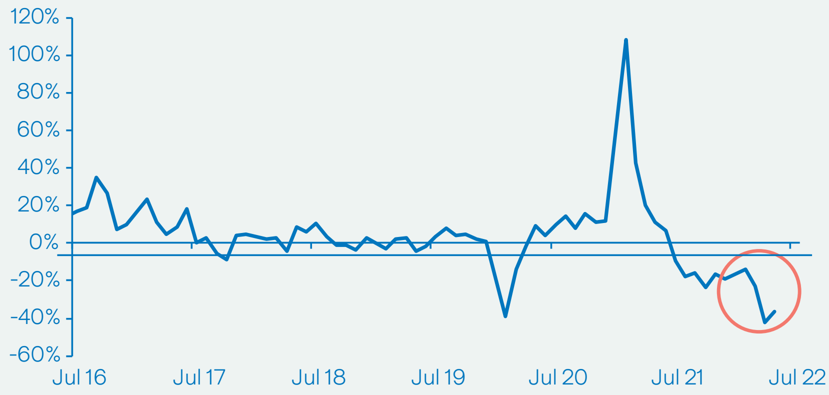
Eurozone wage growth is rising from a very low base



Source: Bloomberg, ECB

The startling fall in retail sales in May by 11% YoY, and a near 40% plunge in home sales, emphasises how devastating the impact of Covid has been.

The China housing market is expected to recover from a dismal period



Source: NBS

The ECB has many spinning plates and must avoid fractures within the region

Given the level of inflation and the ongoing energy gains, we expect the ECB to start tightening policy in July for the first time in 11 years, and to take rates back into positive territory by September. While this is not a bad thing given the distorting effects of negative interest rates, we are emphatic that detailed plans are urgently required to show that fragmentation of member states' borrowing costs will be avoided. This is particularly important for Italy, where debt is now 150% of GDP, but it will be a difficult juggling act for the ECB in light of raising interest rates, slowing growth and critical voices from some of the other member nations. We see a mild recession for the region over the winter months helped by the momentum in the labour market, still high household cash deposits, and relatively limited imbalances, though risks are to the downside. We also see the need for further fiscal measures to ease the cost burden of surging fuel costs.

China bucks the trend

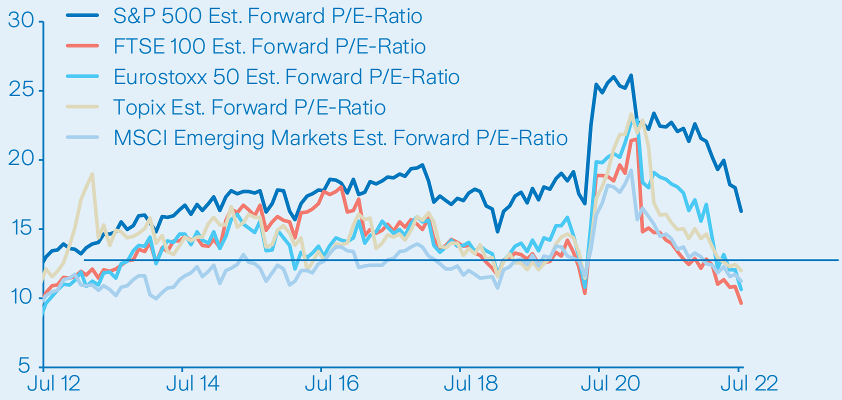
Following a torrid spring that saw around a third of the population under some form of lockdown as the zero-Covid policy was enforced, the Chinese economy is rebounding and policy is easing. The startling fall in retail sales in May by 11% YoY, and a near 40% plunge in home sales, emphasises how devastating the impact of Covid has been, resulting in 33 explicit relief measures being announced by the government. With real estate representing close to 20% of the economy and housing a major store of value for Chinese households, great efforts are being made to stimulate activity. Generally, stimulus is being channelled via fiscal measures, but mortgage rates have been cut and down payments for both primary and secondary homes eased. The auto sector is seeing tax incentives extended for new vehicle purchases as consumption becomes a key focus for President Xi with both the Communist Party Convention and his own re-election looming in the autumn. We have an above consensus view of growth for the year at 4.5%, but below the official growth target of around 5.5%. This would mark the first official miss since the 1980s. Importantly, inflationary pressures remain modest and producer price gains are falling back sharply, which will be helpful for global inflation.

A world of mixed fortunes

Japan is the only other major economy that is not tightening and is content with policy on hold as it maintains 10yr JGB yields below 0.25%, though we suspect this could be adjusted. Growth here is also recovering from the blight of Covid, with the Purchasing Managers Index for June the highest since 2013. Despite inflation at 2.5%, a seven-year high, the yen at a 23-year low against the US dollar, and growth recovering quite sharply, we suspect that policy will remain supportive. On the fiscal front we expect additional stimulus to be announced following the Upper House elections in July to safeguard the recovery. Elsewhere, LatAm faces mixed fortunes with political uncertainty in Brazil and Chile. The commodity boom has also been a double-edged sword as we write in our Topical Thought paper, with the jump in domestic energy and food prices undermining the benefits from commodity exports. Following the aggressive rate hikes in the region over the past year, some moderation is expected as inflation looks close to peaking, though any rate cuts still seem to be some way off.

Although analysts remain too optimistic, investors appear to have already factored a potential earnings recession into their assessment.

Market valuations plunge and are optically attractive



Source: Bloomberg

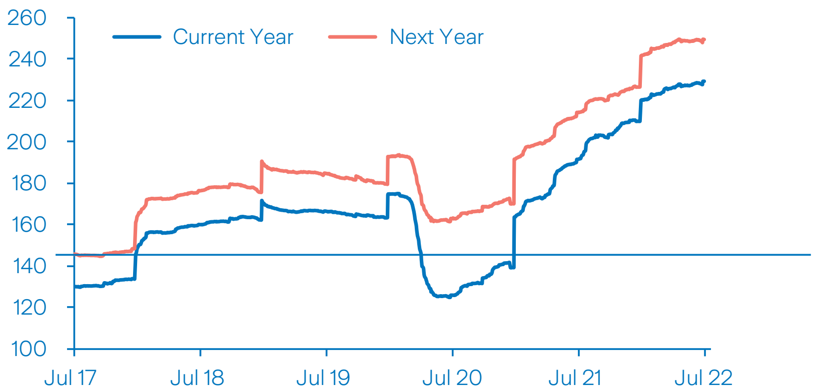
Equity markets price recession

It was thought that earnings growth and a continuation of the economic cycle would support equity markets this year, however, this has not proven to be the case. Stocks have had one of the worst first-halves of a year since the Great Depression, with many markets in bear market territory, being off more than 20% from their highs. Indeed, the median decline for the S&P 500 index during the 12 recessions since the 1940s has been 24%, so it is clear that this year's drop is unusually large with growth still above trend. While stocks have historically fared well in the early stages of tightening cycles as earnings and margins remain good, it has not been the case this time. Investors have deemed central banks to be behind the curve and making it necessary to be more aggressive as a consequence. With earnings and margins still close to record levels in many regions, the falls in equities have resulted in multiple compression. Investors are no longer prepared to pay high valuations in a world of rising rates and higher bond yields. Following the abundant liquidity that lifted all assets, the regime shift has spooked investors and banished the concept of buying the dips. Both private and institutional investors have adjusted their exposure away from stocks, with cash and money market funds being used as havens. That noted, corporate stock buying has been very strong, with stock buybacks hitting a record level in the first half of the year in the US.

Multiples misleading as earnings expectations start to fall

While price-to-earnings ratios are looking attractive, with US multiples now below their 10-year average according to Factset, the issue is that these multiples can be misleading as earnings expectations are only now starting to be tempered. The strong global demand and pricing power that companies have enjoyed is changing. Earnings are currently significantly above trend, and analysts still expect them to grow in the high single digits both this year and next. This seems unlikely, and we see meaningful declines as the European and US economies head towards recession. That noted, while analysts remain too optimistic, investors appear to have already factored a potential earnings recession into their assessment. Investor sentiment has hit multi-decade lows on some measures, and our own proprietary models now indicate over-sold conditions in the short term.

S&P 500 analyst earnings estimates in USD are too optimistic



Source: Bloomberg

While growth stocks such as technology and media have underperformed value sectors such as utilities and healthcare quite significantly this year, we see this fading.

Equities have been hit hard, but value stocks less so than growth

Source: Bloomberg

rebased to 100 on 1/1/22

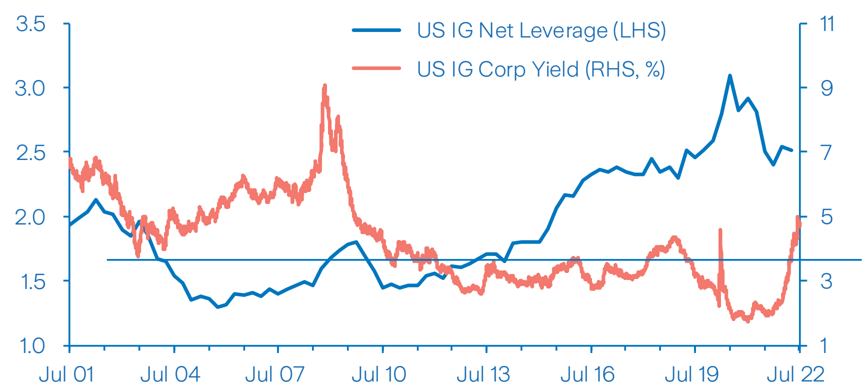
Too early for a structural shift higher for stocks

While volatility will remain high and offer short-term opportunities, the structural bull market remains broken for the time being, with the direction of least resistance still down. To form a durable bottom, we need to see a number of changes to current conditions. It will be critical for tangible evidence to emerge that inflation has not only peaked but is on a trajectory to move towards targets. This will allow interest rate expectations to also peak and give investors the ability to adjust discount factors applied to future earnings and dividend streams. Unfortunately, both conditions are still some months away. Earnings expectations also need to be adjusted to reflect the challenges ahead more adequately. To that point, the current Q2 earnings season will be critical in terms of company guidance. In the meantime, volatility will remain high, as is generally the case in mature cycles. While growth stocks such as technology and media have underperformed value sectors such as utilities and healthcare quite significantly this year, we see this fading. As economic conditions deteriorate, investors are more inclined to seek growth stocks, while the peak in bond yields should also reduce the tailwind for value names. Consequently, a more mixed and nuanced environment is expected as both companies and investors focus on earnings resilience.

Credit markets down, but not out

Credit markets have been part of the holy trinity of asset classes under the cosh this year, along with bonds and stocks, though fundamentals remain reasonable. As with stocks, investor flows have been negative as rates have risen and spreads widened, with the latest bout of angst seeing the sharpest pace of outflows from Investment Grade (IG) credit since the depth of the Covid crisis in March 2020. Not surprisingly issuance has been sparse and sporadic, with High Yield (HY) facing a 'buyers' strike'. Consequently, new issuance concessions for both IG and HY have increased to lure investors. From a company perspective, the good news is that funding requirements are relatively modest, with the recent years of exceptionally low rates and spreads being used to increase and term-out financing. In addition to improving liability profiles and interest coverage ratios, leverage has declined over the past two years from elevated levels. However, although capital spending has been running at a fairly anaemic level, the record stock repurchases in the US this year warrant monitoring. While the funding backdrop has changed, with IG yields hitting the highest levels since the financial crisis back in 2008, companies remain well positioned for the time being, even in the HY space. Bloomberg data show peak maturities in 2025 for European HY and not until 2029 for US HY, affording room to manoeuvre for even lower quality issuers.

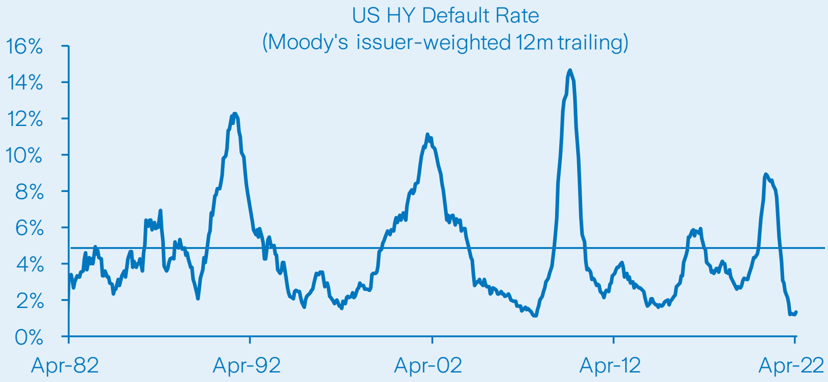
Leverage still historically high as funding costs rise



Source: Bloomberg

We continue to be constructive on the fundamentals of IG credit in both the US and European markets.

Default rates are extremely low, with the direction of travel now higher



Source: Blomberg

High Yield less attractive with defaults rising

We continue to be constructive on the fundamentals of IG credit in both the US and European markets, though less so on HY, which is more exposed to recessionary risks and remains rich on a relative basis. HY has not corrected to the same extent as IG, despite its riskier nature. While defaults will turn higher, we see them peaking in the 4-6% range given balance sheet strength and the relatively short and mild nature of recession compared to recessionary averages of closer to 10%. However, the direction of travel for defaults will be higher.

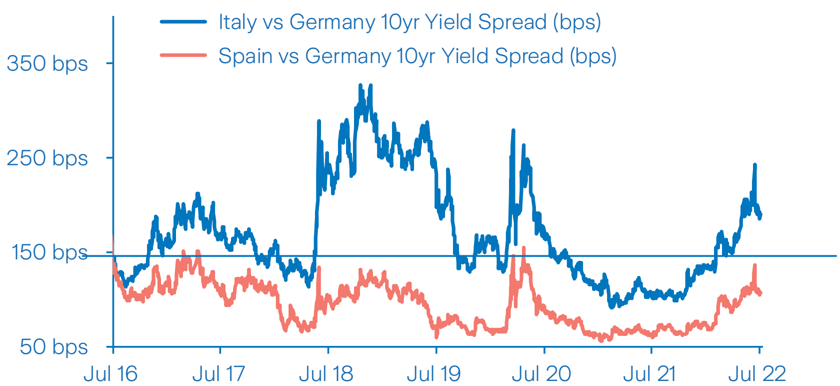
Investment Grade in decent shape but offering less potential than stocks

European IG appears to have priced in a mild recession and is becoming increasingly attractive, with spreads per unit of leverage now closing in on Covid peaks. While we suspect risks are still to the downside over the medium term, given our recessionary view, much now appears to be in the price. The light positioning of investors, negative outflows and still strong balance sheets suggests that a bounce is likely in the near term, while longer-term recessionary risks will likely cap gains. We continue to favour equities over credit, which offer greater upside potential once inflation and rates peak, while downside risks are similar.

The safe haven of government bonds proves ill-founded this year

The dramatic decline in government bond markets this year, with yields hitting the highest levels in ten years, has coincided with risk-off sentiment. This relatively unusual phenomenon indicates that inflation fears and rising policy rates have undermined the safe haven status usually accorded to bonds. Data from Deutsche Bank indicate the worst first half of the year for US Treasuries since 1788, while bond market volatility has surged, giving investors few places to hide. The critical change has been the volte-face of central bankers, with the pace and magnitude of rate hikes catching investors off guard. The 50bp tightening by the SNB that lifted 10yr bonds to within a whisker of 1.5% being the latest surprise. Indeed, the value of negative yielding fixed income securities has shrunk dramatically as government bond yields have risen, falling to USD 1.4tn from the highs last year of USD 18tn, comprised mostly of Japanese government bonds. Not only are the moves in policy rates driving bond yields higher, but quantitative tightening is now at play, with the US Fed and BoE shrinking the size of their balance sheets and the ECB on the cusp of ending PEPP (though continuing to reinvest maturities). In the case of the US, we estimate the run-off this year and next equates to around 50-75bps of additional tightening.

Rising funding costs for key Eurozone members forces the hand of the ECB



Source: Bloomberg

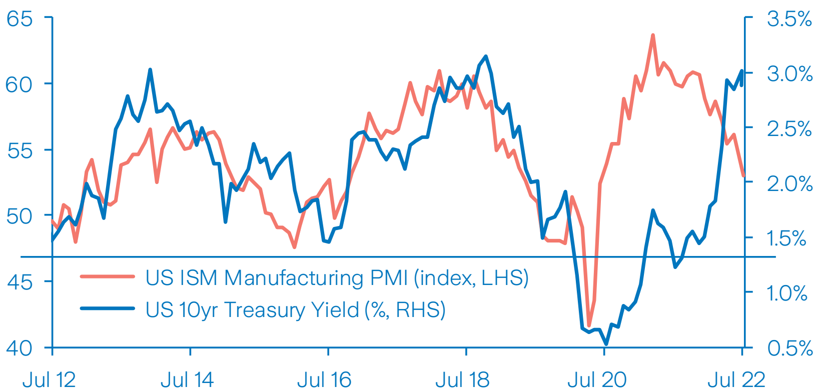
Ignore inversion at your peril

Having fleetingly inverted back in April, the Treasury curve is indicating that the probability of recession within the coming 12 months is indeed high. While not infallible, we do put weight on the messaging from the curve, which corroborates our own fundamental outlook and suggests that the pace and magnitude of global rate hikes is likely to moderate soon. The Fed's dot-plot implies a further 175bps of tightening by the end of the year, while the ECB has indicated that policy rates will be in positive territory from the current -50bps by September. We see the former as too aggressive, given our expectation of slowing growth and peaking inflation, while the latter will be dependent upon concurrent policy to mitigate any fragmentation of peripheral funding costs. Italy's BTP yields hit 4% on the hawkish ECB rate projections, before being calmed by a subsequent emergency ECB meeting that committed to curbing spread widening of peripheral bonds.

Yields are also in the process of peaking

In aggregate we now see limited upside in bond yields given the dramatic move in both real and nominal rates. Our analysis suggests yields are more reflective of the underlying fundamentals. While overshoots in such volatile markets should be expected, we suspect that yields are likely to moderate through the end of the year as inflation peaks and recession prospects are more widely acknowledged.

ISM data suggest downward pressure on bond yields as growth slows



Source: Bloomberg

Conclusion

Economic and market cross-currents have seldom been greater in a year that started out with optimism. War and enduring pandemic outbreaks put paid to that sentiment. However, it has in part been the strength of consumption in developed markets that has perpetuated the rise of inflation and the policy response that it demands. To us, the challenge of managing economic activity and timing interventions in the midst of a war and supply shocks leaves risks clearly to the downside. We suspect that slowing growth and moderating inflation will require a more gentle policy response than is currently being priced. However, until we actually see the twin peaks of inflation and interest rates, the road for economic activity and financial markets will not be without pain.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd
Group Investment Management
Mythenquai 2
8002 Zurich

P0282265 (07/22) TCL

ZURICH