

## Executive summary



SPRING 2022



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The two-week-old war between Russia and Ukraine and the global response to the conflict are evolving rapidly, and in a way that suggests the trajectories of economic growth and financial-market performance have been significantly altered from just a month ago. Although we continue to think that the most likely outcome is for the global economy to continue expanding, we now expect slower growth and higher inflation, and we presume that the odds of recession have increased.

### Geopolitical tensions flare up

Russia delivered on its threat to go to war with Ukraine and the invasion has opened up the possibility of a drawn-out period of uncertainty. While there are potential paths to a resolution if Ukraine and NATO agree to Russia's demands, an agreement seems unlikely at the time of writing. From an economic perspective, Ukraine's economy has been devastated and Russia is being subjected to harsh sanctions limiting flows of money, goods and technology. Aside from shock and revulsion from this unprovoked aggression, the main

near-term impact on the rest of the world is through lower supplies and higher prices for commodities, which will be most harmful to European countries given their reliance on Russian energy. We project a 0.7% reduction in the eurozone's 2022 GDP growth to 3.0% and a 0.3% decrease in U.S. growth to 3.1%. From a long-term perspective, the Russian-Ukraine war brings a range of potential implications including a new Cold War, increased military spending, nuclear proliferation and a heightened motivation to shift energy supplies toward renewables.

### Economic recovery slows

Although the pandemic continues to recede and consumer and business spending is rising, their impact on growth is much less pronounced than it was a year ago. Moreover, a tightening of financial conditions, slowing Chinese growth, reduced U.S. government spending and elevated inflation were already working to undermine the economic expansion as the Ukraine conflict began. As a result, our forecasts for 2022 have moved somewhat lower from last quarter, and remain below the consensus. Global growth

is set to decelerate to 3.6% in 2022 from 6.2% in 2021. Developed-world growth should fall to 3.0% from 5.1%, while growth in emerging markets is set to slow to 4.1% from 7.3%. It's worth noting the significant uncertainty around these assumptions given that the damage from sanctions on Russia is particularly unclear. As a result, we believe the risk of U.S. recession in 2022 is significantly higher, at somewhere between 25% and 50%.

## Higher inflation for longer

Inflation is running at its highest levels in several decades, now above 7% in the U.S. and approaching 6% in other nations. The main drivers are surging commodity prices and supply-chain problems, but smaller factors include stimulative central banks, labour shortages and a housing boom in much of the world. Inflation is likely to rise even further in the short run due to the war in Eastern Europe. Offsetting some of these inflationary forces over the next year might be an easing in supply-chain pressures and the

economy-dampening impact of central-bank rate hikes. Taken together, we anticipate high and above-consensus inflation for 2022, but with a decelerating trend during the second half of the year. We continue to believe that inflation will, over a longer-term horizon, eventually fully revert to normal, with aging populations and slower population growth even bringing inflation down below historical norms.

## Currency landscape altered by Russia-Ukraine conflict

The currency landscape has been altered by the freezing of Russian foreign-exchange reserves following the country's invasion of Ukraine. The short-term impact of the conflict has been a rise in the U.S. dollar as investors seek the safety, security and liquidity associated with U.S. assets. But the longer-term consequences of the war,

which include higher commodity prices and a reluctance among countries to accumulate reserve assets, will create headwinds for the greenback. In this environment, we expect that commodity currencies will be the clear winners.

## Central banks respond to inflation pressures

The war may ultimately reduce the amount of monetary tightening that would have otherwise taken place, but this year is still expected to be one when most developed-world central banks move ahead with rate hikes to temper inflation. We look for four 25-basis-point rate increases from the U.S. Federal Reserve (Fed), the Bank of England and the Bank of Canada (after having hiked once on

March 2) this year and none by the European Central Bank. We estimate that four rate increases theoretically reduces a country's economic growth by 0.5% over the following 18 months – far from a recessionary impact. But the speed at which central banks flipped to tightening mode presents at least some risk to economic growth and markets.

## Recent jump in yields moderated near-term valuation risk, but the long-term direction for yields likely remains up

Rising rates and higher inflation pushed bond yields sharply higher at the start of the year. The U.S. 10-year yield rose more than 50 basis points to above 2.00% between the end of November and early February. But the potential hit to growth from the war boosted demand for safe-haven assets and pulled yields lower toward the end of the quarter. Our models continue to suggest that the long-term direction for yields is higher, mostly due to the fact that real, or after-inflation, interest rates are unsustainably low at -2.8%, their lowest level in 60 years.

While there have been a variety of global GDP headwinds to real rates ranging from aging global demographics to lower potential growth rates to an increased preference for saving versus spending, even placing them at 0% would provide substantial upward pressure on nominal bond yields. We recognize there are some war-related risks to economic growth that could temporarily limit the increase in yields, but our expectation for higher nominal yields over the longer term sets up a scenario where sovereign-bond returns are low or even slightly negative for many years.

## Stocks enter correction, improving return potential as long as earnings come through

After a strong 2021, global equity markets tumbled in the first two months of 2022 as major indexes experienced declines of 10% to 20% from their recent peaks. The major concern for equity investors at the start of the year was the prospect of tighter Fed policy, prompting a significant cut to the valuations of the market's most expensive companies, in particular. While the war in Ukraine is causing stock-market volatility, economic growth and earnings are forecast to continue rising, albeit at a slower pace. We have cut our estimate of

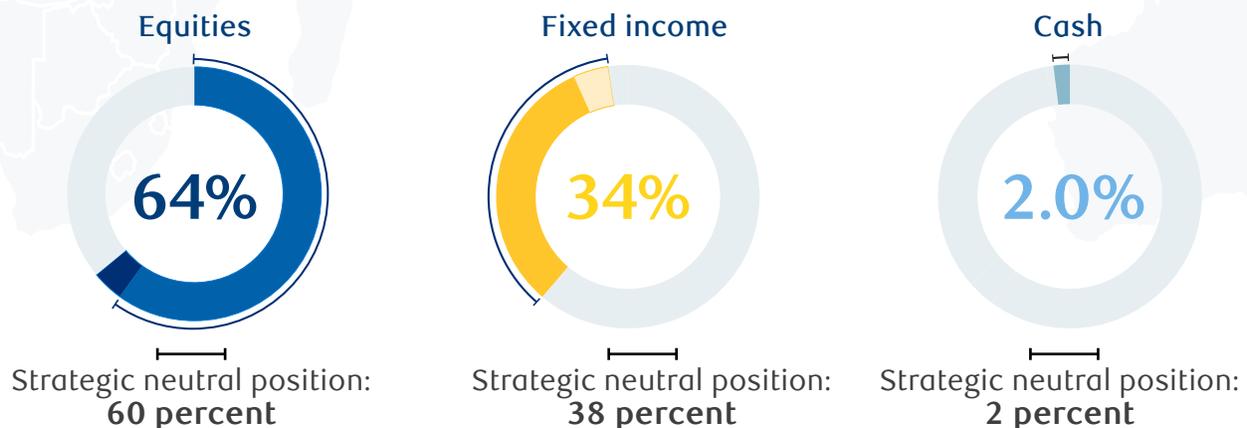
nominal U.S. GDP growth to 9.0%, which still translates to relatively strong earnings growth of 16.4%, based on our regression model. The consensus of analysts' estimates is for just 8% profit growth this year, so there is still a decent cushion against the uncertainty created by the war in Ukraine. Moreover, given that measures of investor sentiment are extremely pessimistic and valuations have come down, any indication that the outlook is improving could result in a significant positive swing in investors' attitude toward stocks.

## Asset mix – re-deployed cash to bonds and stocks at more attractive levels

The distribution of potential outcomes spans an unusually wide range as a result of the war, surging commodity prices and a tightening of financial conditions, and we recognize that the odds of a negative scenario have increased meaningfully. Within the spectrum of possibilities, our base case continues to look for an extension of the global economic expansion, a peak in inflation by the end of the year and central-bank rate hikes. The significant re-pricing in assets since the start of the year has provided us with an opportunity to re-commit some of the cash we had built up over the past two quarters. We added 0.5% to our fixed-income allocation in recognition that the recent rise in yields reduces near-term valuation risk and provides a better cushion against

a downturn in the economy. But we remain underweight fixed income overall given our longer-term view that they will deliver low to slightly negative returns as yields rise. We also added 0.5% to our equity allocation as stocks sold off in the early days of Russia's invasion of Ukraine, which reduced valuations and boosted return potential under the assumption that solid nominal GDP growth will continue to support gains in corporate profits. We have retained a 2% cash reserve should further opportunities present themselves. For a balanced, global investor, we currently recommend an asset mix of 64.0 percent equities (strategic neutral position: 60 percent) and 34.0 percent fixed income (strategic neutral position: 38 percent), with the balance in cash.

## Recommended asset mix



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Publication date: March 15, 2022