BARINGS INVESTMENT INSTITUTE

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Listening for the Tectonic Shifts

MACRO DASHBOARD

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May Outlook – Listening for the Tectonic Shifts

In a spring full of disorienting headlines, the three most salient developments have been the continuing **commodity price spikes** from Russia sanctions, the **COVID lockdowns** that threaten Chinese growth, and the **hawkish turn** by some of the world's largest central banks. These will shape financial markets most over the next year, but **listen for sounds of more structural shifts** in the economic and political order as well. Sooner or later, these will shape markets, too.

For now, we continue to give slightly better odds to our **Stagflation Shock** scenario, which has rising prices taming growth later this year. But we acknowledge that recovery momentum remains strong, which could deliver growth and inflation that linger **Higher for Longer**. Our **Fine Balance** scenario, in which prices moderate on their own as supply chains normalize, now looks like a longshot.

The U.S. economy remains robust with workers enjoying strong wage growth and ample savings buffers. Spending still looks healthy and the latest PMI surveys record strong activity. It's still hard to imagine a U.S. recession anytime soon, but consumer spending will surely cool as food, fuel, and housing costs all move higher.

We are also keeping a close watch on **long-term inflation expectations**. These have been anchored so far but could deliver a longer period of higher prices without hurting growth. Commodity shortages and slow normalization of supply chains predate the Ukraine war and may signal something more enduring.

In Europe, the labor market is still strong and spending looks healthy, but **the shocks from Ukraine are obvious**. Lining up alternative energy suppliers may come over a few years, but the transition will add to the continent's costs. Governments are helping cushion the blow with tax cuts and subsidies. Strong reopening momentum and a relatively accommodative European Central Bank could deliver above-trend growth, but a sudden embargo on Russian energy threatens recession.

Here, too, there are deeper shifts afoot as the continent digs in on its commitment to Kyiv and isolation of Moscow. This will mean finding new trading partners to replace Russia and more defense spending. This comes on top of large spending promises to accelerate the green transition and a fresh attempt to rethink the iconic spending limits within the Maastricht Treaty.

In **Asia**, the most worrying news has been China's fresh outbreak of COVID that has **triggered lockdowns** covering nearly one-third of the population and scuppered the recovery in domestic consumption. The impact on production appears limited so far, but global supply chains may soon feel additional disruptions. Meanwhile, the **Bank of Japan** persists with its policy of **yield curve control** to bolster economic growth, even as the yen plumbs new depths amid rising global rates.

The much bigger shift looks underway in Asia, as **Russian sanctions divide its major economies**. The Chinese government continues to offer tacit support for Moscow, and other regional economies may expand their Russian trade in spite of U.S. warnings. These tensions likely won't affect the durability of this economic cycle but may well alter long-term investment flows that give shape to the next.

If it feels like the ground beneath your feet is shifting, it is.

--Christopher Smart

Barings Investment Institute Scenarios for the Next 12-18 Months

A FINE BALANCE (10%)

- **Energy prices rise** with international sanctions in response to Russia's attack on Ukraine, adding to inflation pressure left over from the pandemic.
- **Central banks respond but not too briskly,** fine-tuning their reaction to rising inflation because of the risk to growth from war in Europe.
- **Inflation slows down around the turn of the year** from the hit to growth and progressive de-escalation in Ukraine. Recovery from the pandemic and fiscal spending in Europe keep growth above trend.
- Markets price in success of this very fine balance: **central banks will curb inflation and support growth**.
- **Policy hikes:** FFR to 1.25%
- **10-Year U.S. Treasuries**: **2.5%** with curve **steepening**
- **Market Implications**: Supportive of equities, commodities, USD. Negative duration.

HIGHER FOR LONGER (40%)

- **The oil shock** adds to lingering labor shortages and the green transition, at a time of commodity shortages.
- **Household strength** provide firms with pricing power to pass through higher input costs. Banks have space to lend and help the economy buffer rising inflation.
- **Central banks are too cautious** in tightening financial conditions. The impact of policy is insufficient to bring inflation down fast.
- **Growth remains above-trend while inflation stays higher for longer**.
- **Policy hikes:** FFR to 4.5%
- **10-Year U.S. Treasuries**:
  - Settles at **6%**
  - The curve **steepens**
- **Market Implications**: Supportive of banks, commodities, break-evens, firms with pricing power. Negative EM and duration.

STAGFLATION SHOCK (50%)

- **Inflation rages on**. This is a commodities shock for the history books. Pipelines may get disrupted or there is a Russian oil embargo.
- **Central banks tighten aggressively** to reign in inflation expectations.
- **Demand is destroyed,** hammered by inflation and tighter financing conditions. **The adverse growth impact** on Europe is much stronger than on the U.S., given energy dependence on Russia.
- **With inflation far above target and aggressive policy tightening, Europe risks a recession, the U.S. faces a slowdown**.
- **Policy hikes:** FFR: 3%
- **10-Year U.S. Treasuries**:
  - Settles at **2.5%** in 12-18 months
  - The curve first sells off across all maturities and **bear flattens**
- **Market Implications**: Volatility. Supportive of USD, TIPS, gold, floating rates. Negative risk and duration.

Scenario Matrix—Economy

		Scenarios						
		A Fine Balance		*Higher for Longer*		*Stagflation Shock*		
		2022	**2023**	**2022**	**2023**	**2022**	**2023**	**Baseline scenario**
U.S.	Growth	3%	2.5%	4%	3%	2.5%	1.5%	The energy and commodity price shock from the war in Ukraine is expected to **add to already-elevated inflation**. The Fed will need to hike rates in response. Meanwhile, higher energy and food prices will weigh on consumers, and, without a fully offsetting rise in capex, should **slow growth**.
	Inflation (AOP)	4.5%	2.5%	6%	4%	7%	5%	
	Unemployment	3.5%	3.5%	3%	3%	3.5%*	4.5%*	
Euro Area	Growth	3%*	2%*	3.5%	2.5%	2%	-1%	Uncertainty on the extent of the **energy price shock** and its policy response in Europe mean the war could have a differing impact on the growth-inflation path. The baseline assumes an oil embargo and little ability for policy to rapidly smooth the impact on the economy.
	Inflation (AOP)	5%*	2%*	7%	3%	8%	4%	
	Unemployment	6.5%	7.5%*	6%	8%	7%	10%	
Japan	Growth	2%*	1.5%	2.5%*	2%	1.5%	1%	A combination of **higher commodity prices and weaker FX** is likely to lead to stickier inflation but unlikely to see sustained breaches above 2%, given the still-weak consumption recovery.*
	Inflation (AOP)	1.5%	1%	1.5%	1.5%	2%	2%	
	Unemployment	2.5%	2.5%	2.5%	2.5%	3%	3.5%	
China	Growth	5%	5%	5%*	5%	4.5%	4.5%	**Supportive monetary and fiscal policy** should help cushion downside risks, though "bazooka" stimulus is unlikely. Inflation risks are to the upside but will be tempered by weak internal demand.*
	Inflation (AOP)	2%	2.5%	2.5%	2.5%	3%	3%	
	Unemployment	3.5%	3.5%	3.5%	3.5%	4%	4.5%	

The above represent the views of Barings as of April 25, 2022, and are subject to change at any time. These predictions may not come to fruition.
Notations: AOP refers to the annual average of period. Asterisks indicate updated estimates from the last publication.

Scenario Matrix—Central Bank Policy

	Scenarios		
Central Bank	***A Fine Balance***	***Higher for Longer***	***Stagflation Shock***
FED	Fed Funds Rate: 1.25% Following the end of taper, rate hikes start in March and quantitative tightening (QT) begins in 2022*	Fed Funds Rate: 4.5% Higher, stickier inflation takes hold as demand proves resilient. The Fed does not tighten policy enough	Fed Funds Rate: 3% The energy shock causes a surge in inflation, and, following liftoff that began in March, the Fed is aggressive to bring it under control
ECB	Inflation takes a hit then declines in line with expectations; the ECB hikes once in 2022 and again in 2023 to bring rates to 0	Inflation forces the ECB to speed up tapering and rate hikes. It brings rates to 0 in 2022 and 1% in 2023	The ECB normalizes the policy rate to 0 in 2022 or the start of 2023 and then stops
BOJ	Policy rate stays negative; yield curve control (YCC) is kept in place to allow the FX channel to keep inflation expectations firm until inflation target is reached	Policy rate stays negative; yield curve control (YCC) is kept in place to allow the FX channel to keep inflation expectations firm until inflation target is reached	Policy rate stays negative; inflation surprises or excessive yen depreciation could see YCC bands widened or the target maturity shifted lower
PBOC	Steady easing, focusing on window guidance and balance sheet action, with the addition of policy rate cuts	Steady easing, focusing on window guidance and balance sheet action, with the addition of policy rate cuts	Steady easing, focusing on window guidance to promote credit growth, with policy rate cuts as a secondary tool*

The above represent the views of Barings as of April 25, 2022, and are subject to change at any time. These predictions may not come to fruition. Asterisks indicate updated estimates from one month ago.

Scenario Matrix—Markets

Scenarios			
Markets	***A Fine Balance***	***Higher for Longer***	***Stagflation Shock***
Rates	10Y UST around 2.5%; curve steepens	10Y UST settles at 6%, led by breakevens; curve bear steepens	10Y UST settles at 2.5%; the curve sells off across all maturities and bear flattens before trending down as the economy slows down*
Corporate Credit	Negative duration	Negative duration; positive credit amid robust economic growth	Negative duration and credit
Equities	Positive quality as economic momentum continually slows, but remains positive	Weak returns on contracting multiples. Positive financials and commodity-linked names, and on companies with high pricing power	Defensive and commodity-linked sectors
FX	Supportive dollar on U.S. rate differentials	Neutral dollar as other DM central banks catch up to the Fed's hiking cycle	USD strengthens in flight to safety and rate differentials*
Commodities	Modestly positive commodities on supply shock, but global activity remaining robust should keep prices elevated	Positive commodities on supply shock, but global activity remaining robust should keep prices elevated	Positive commodities on supply shock, before pulling back as activity contracts sharply; precious metals see safe haven flows

The above represent the views of Barings as of April 25, 2022, and are subject to change at any time. These predictions may not come to fruition. Asterisks indicate updated estimates from one month ago. 10Y UST projection is for end of period.

What Changed Since March

WHAT'S NEW

- **Hawkish Fed pivot** leads markets to price in more aggressive path of rate hikes
- **ECB** moves to tighten, too, as European energy shocks intensify in the effort to reduce Russian imports
- **COVID** is improving and restrictions unwinding…
- … except in **China**, where lockdowns are getting worse
- The **BOJ's yield curve control policy,** balancing yen depreciation, growth and inflation expectations

WHAT WE LEARNED

- **War in Ukraine** looks like it will be long and protracted as neither side is ready to back down
- **Most of Europe is willing to pay a much higher price** to lessen reliance on Russia
- **China remains committed to zero-COVID policy,** despite economic and potentially societal and political damage

WHAT WE ARE HEARING FROM OUR TEAMS

- High yield spreads still aren't pricing in any downturn
- Securitized team expects credit normalization in the next 12-18 months, as delinquencies among consumer loans gradually increase from historic lows to more normal levels
- Despite some improving data on supply chains, sector specialists believe volatility and backlogs will likely remain through year-end, particularly given lockdowns in China
- Equities team sees widespread input costs, which could weigh on margins

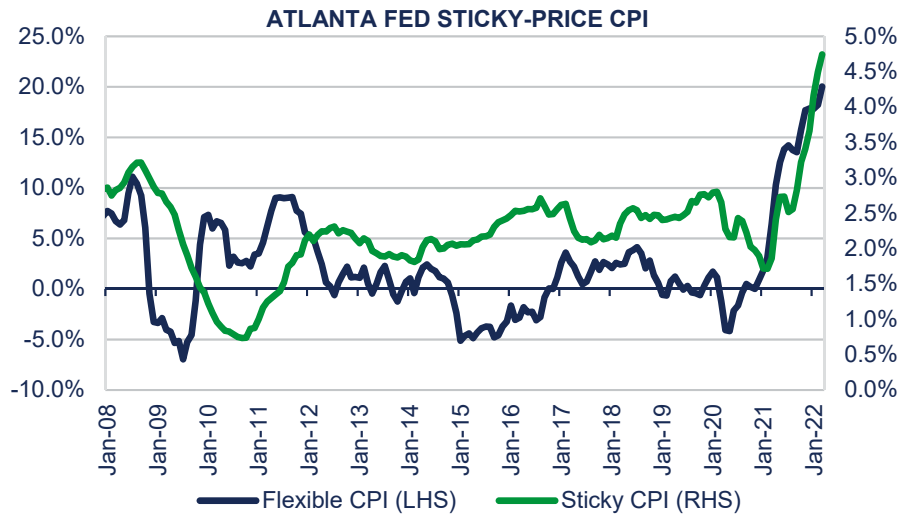
WHAT WE ARE WATCHING

- The **war in Ukraine**
- **Food prices and unrest in EMs**
- **U.S. wage growth**
- **Consumer response** to higher inflation, tighter monetary policy, and greater uncertainty
- **U.S. tensions with China and others** not standing in opposition to Russia
- Impacts of **lingering commodities shock** to the real economy and financial markets

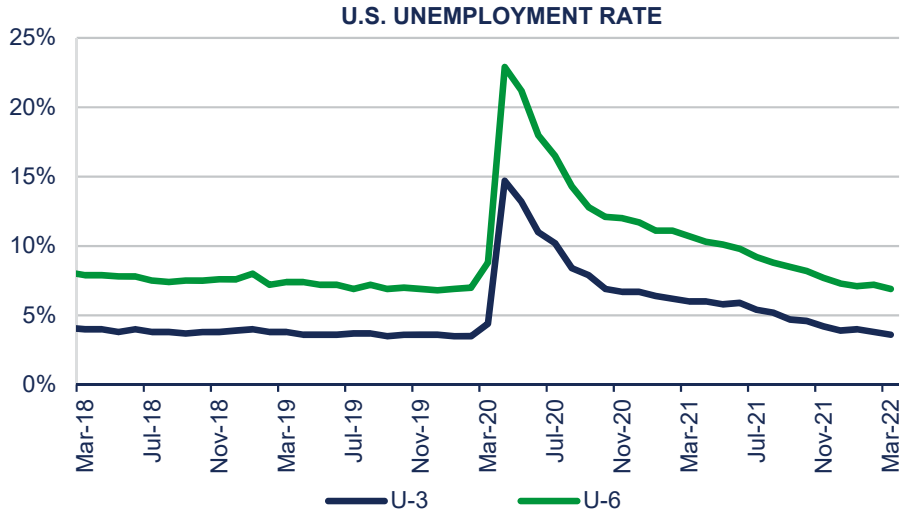
Fed Radar Screen

Inflation is running well above the Fed's average 2% target, exacerbated by the war in Ukraine. Combined with a tight labor market and rising wages, this suggests a more aggressive front-loading of rate hikes by the FOMC.

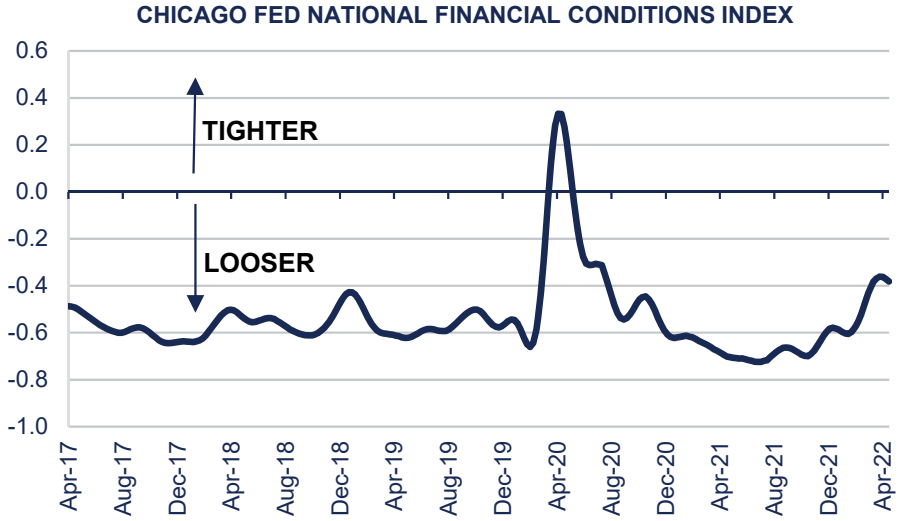
INFLATION: CONCERN



EMPLOYMENT: CONCERN



FINANCIAL CONDITIONS: EASY

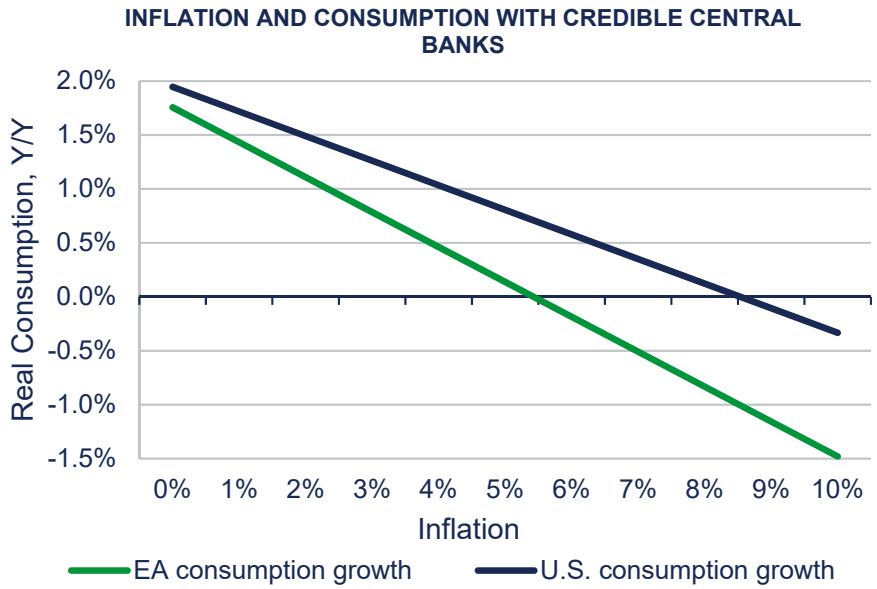


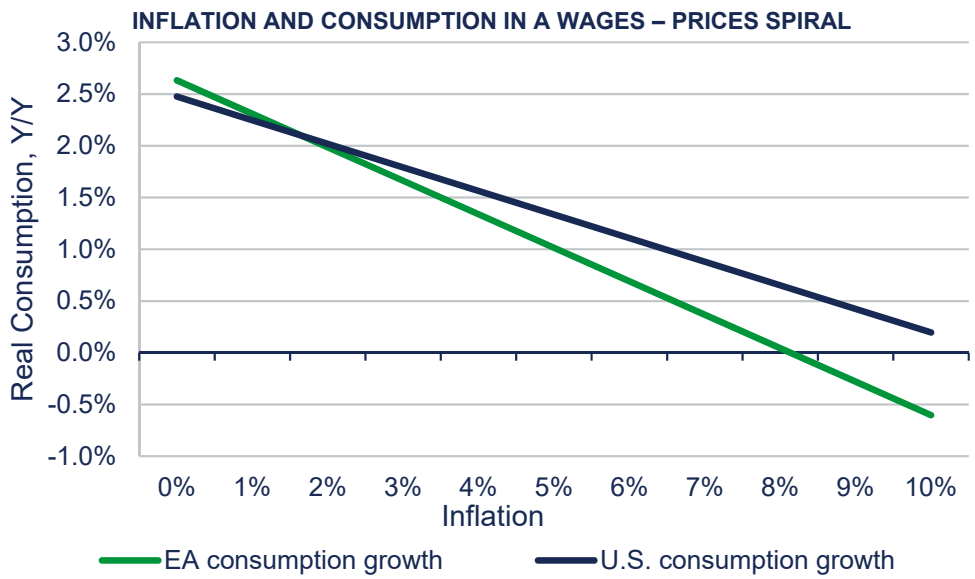
RISKS: CONCERN

World Vaccinations (% population fully vaccinated)	
U.S.	65.1%
EU	73.6%
U.K.	73.9%
India	62.4%
Brazil	76.5%
South Africa	30.3%

Source: Bloomberg and Haver. As of April 20, 2022.

Monthly Spotlight: Will Inflation Kill Growth?





Inflation is fast outpacing wage growth in both Europe and the U.S. **Households are losing purchasing power and becoming poorer**. Two very different outcomes can develop from here:

a) **Credible central banks scenario**: Inflation continues to outpace wage growth, and real income and consumption suffer, eventually bringing a growth and inflation slowdown. Central banks may hasten the path to this outcome by hiking rates.

b) **Wages-prices spiral scenario**: Wage growth picks up as workers demand their purchasing power be protected and, in a context of tight labor markets, they succeed. Real income and consumption are protected, and inflation does not come under control unless (or even if) central banks tighten very aggressively.

Employing the most commonly used models of consumption and its drivers, we estimate the magnitude of inflation needed to cause consumption growth to turn negative. Underlying these models are different assumptions about income and wealth. Given consumption represents between 50% and 70% of GDP in Europe and the U.S., we consider these as the conditions for a recession to unfold.

The chart on the left shows estimated consumption growth at different levels of inflation over the next 12 months, **assuming central banks' credibility keeps wage growth anchored.** In the euro area (green line), inflation averaging 6% over the next 12 months hurts incomes enough to bring consumption and GDP growth into negative territory. In the U.S., given the stronger consumption drivers (wages and employment growing faster), a much higher inflation rate (9%) is needed to trigger a recession.

Things are different **if labor market tightness triggers further wage acceleration** (to 9% in the U.S. and 6% in Europe); the right-hand chart depicts this scenario. As expected, under these assumptions labor income growth is strong enough to compensate for inflation. This has to reach 9% to cause a recession in the euro area, and 11% to cause one in the U.S. This is a 1970s scenario where central banks have lost control.

We conclude that, unless central banks lose control of wage-price dynamics, the rate of inflation currently expected to prevail in Europe and the U.S. in the next year (6%) will act as a substantial drag to private consumption, likely triggering **a sharp slowdown in U.S. growth and a recession in the euro area.**

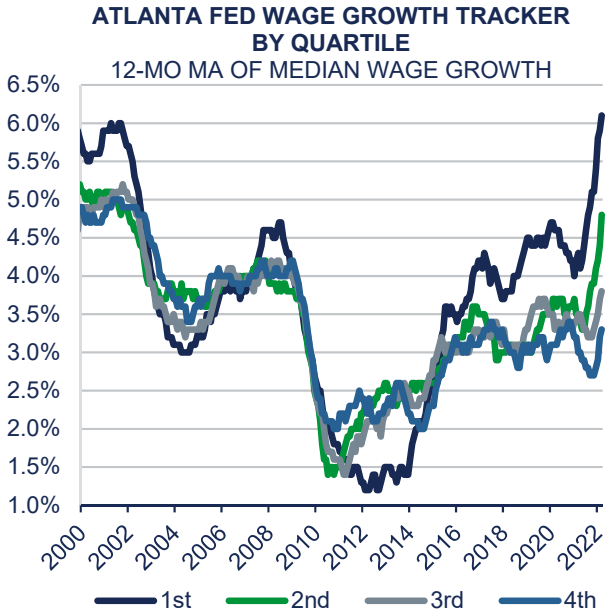
Source: Haver and Barings calculations. As of April 22, 2022.

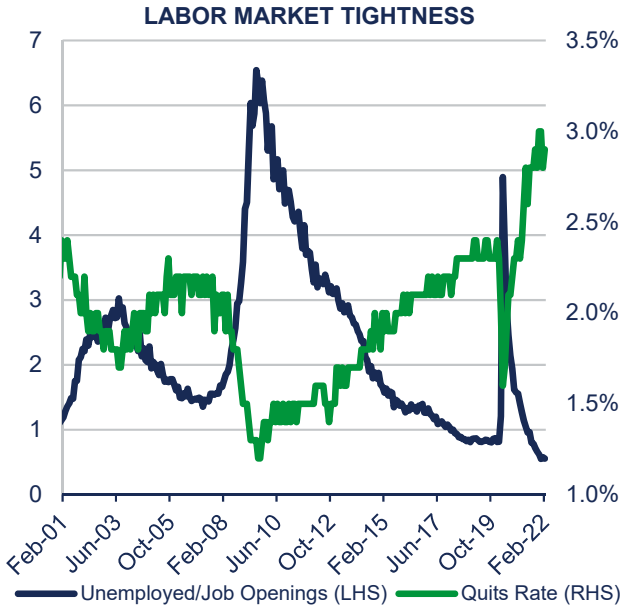
United States

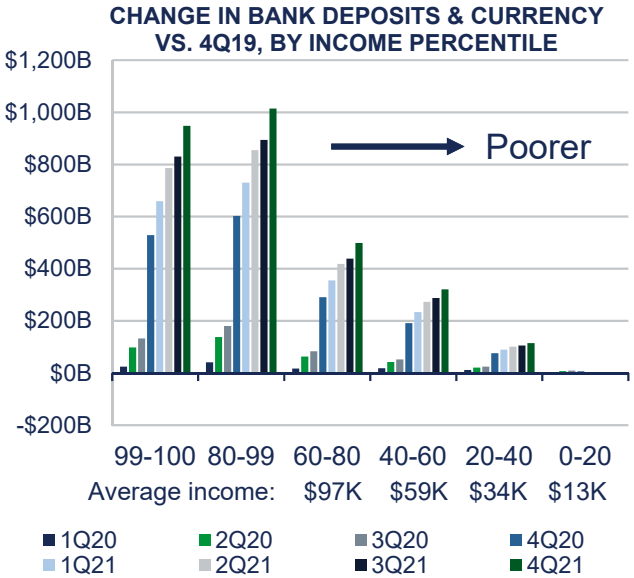
NOMINAL WAGES are rising across all income levels.

THE LABOR MARKET remains extremely tight, which should keep wage growth strong in the near term.

SAVINGS BUFFERS remain elevated, particularly among higher-income groups.







- Wages are rising across all income levels as demand for labor continues to outpace supply.
- Growth in wages is most notable for low-wage sectors, with the Atlanta Fed Wage Tracker showing the 6.1% Y/Y growth in wages for the lowest quartile. This is well-above the pre-COVID pace of about 4.5%.

- There are 5 million more open jobs than unemployed, and the quits rate is at a record high, as demand for labor outpaces supply. The tight labor market is emboldening workers to leave their jobs for higher wages elsewhere.
- This points to risks of a wage-price spiral if high inflation boosts consumers' inflation expectations, and a tight labor market allows workers to further bid up wages in response.
- However, if labor supply continues to return and longer-term inflation expectations remain well anchored, wages could edge lower to a more sustainable pace.

- Bank deposits and currency held by households increased in 4Q21, with the stock of excess savings $2.5 trillion above pre-COVID levels.
- Rising wages are supporting low-income consumers, and the elevated savings buffer is supporting middle- and higher-income groups.
- While elevated inflation and tightening monetary policy should slow the pace of consumer spending, the strong backdrop should allow consumers to avoid a recession this year.

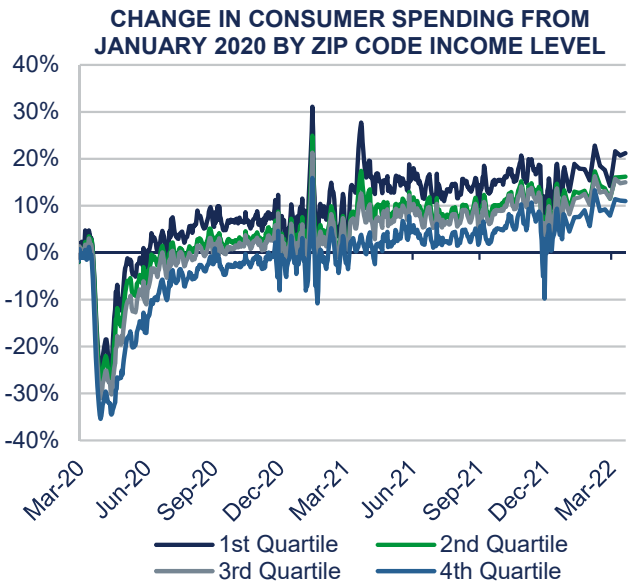
Source: Bloomberg, Haver, and Federal Reserve. As of April 21, 2022.

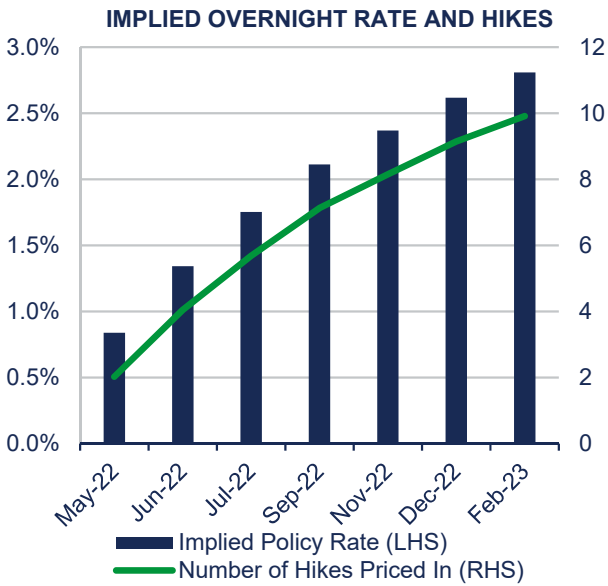
United States

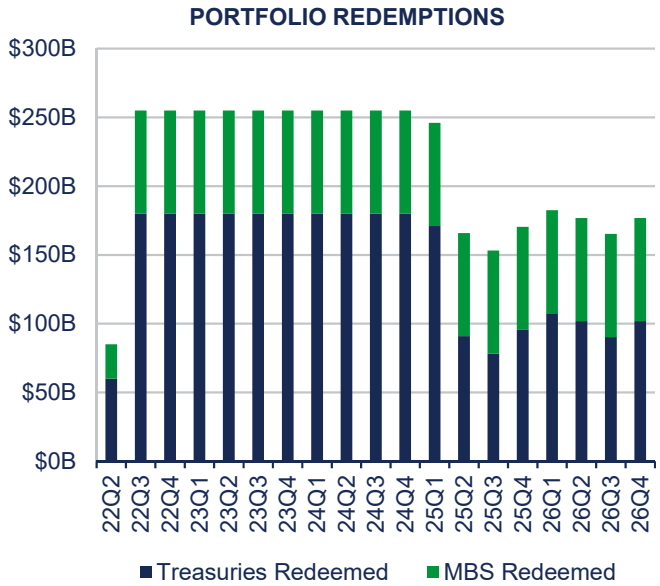
CONSUMER SPENDING remains robust across income groups.

The continued hawkish pivot by the FOMC has pushed rate hike expectations even higher, with front-loading anticipated.

The FOMC is set to begin QUANTITATIVE TIGHTENING, which would lead to even more restrictive policy.







- Despite rising prices and current geopolitical turmoil, U.S. shoppers across income groups continue to spend at a stronger pace than before the pandemic—particularly among the lower-income group (first quartile).
- Higher gas, food, and shelter prices will act as a tax on consumers and should lead to some moderation of consumer spending.
- Meanwhile, pent-up demand for services should allow the service sector to be relatively more resilient than the goods sector in the face of normalizing growth.

- Given the continued hawkish pivot by the Fed, markets are now pricing in nine 25bps hikes this year—up from five at the beginning of March.
- Given comments by Fed presidents, the FOMC is likely to front-load hikes—with 50bps increases priced in for each of the next two meetings—to try to get inflation under control.

- The FOMC is set to announce quantitative tightening (QT) at the May meeting. The runoff of the balance sheet will likely be phased in and subject to caps. The March meeting minutes suggest monthly caps of about $60 billion for Treasuries and $35 billion for MBS per month.
- QT will act to further tighten financial conditions, and, given limited history, uncertainty surrounding market impacts is elevated. If rate hikes prove too much for consumers, the FOMC could shift to rely more heavily on QT to tighten policy.

Source: TracktheRecovery.org, Bloomberg and Piper Sandler. As of April 20, 2022.

CONSENSUS FORECAST

- Our baseline outlook calls for below-consensus growth and above-consensus inflation in 2022 and 2023. This is because we see the energy and commodity price shock stemming from the war in Ukraine boosting already-elevated U.S. inflation and keeping it there for longer. Moreover, higher energy and food prices would act as a tax on consumers, and, combined with tighter monetary policy, should lead to slower growth.
- Our baseline outlook sees a higher unemployment rate than consensus, given expectations for slower growth.

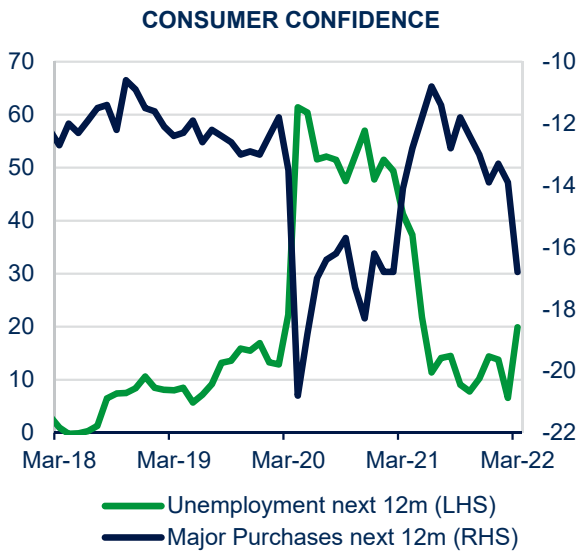
Economic Growth	4/25/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
Real GDP (Y/Y %)	5.5	2.3	-3.4	5.7	3.2 ▼	2.1 ▼
Inflation						
CPI (Y/Y %)	8.5	1.8	1.2	4.7	6.9 ▲	3.0 ▲
Core PCE (Y/Y %)	5.4	1.7	1.4	3.3	4.7 ▲	2.8 ▲
Labor Market						
Unemployment (%)	3.6	3.7	8.1	5.4	3.6 --	3.5 ▲
Rates						
Fed Funds	0.38	1.63	0.13	0.13	2.30 ▲	2.80 ▲
2Y Treasury	2.62	1.57	0.12	0.73	2.74 ▲	2.8 ▲
10Y Treasury	2.84	1.92	0.92	1.51	2.76 ▲	2.88 ▲

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of April 25, 2022. (E)—Bloomberg private market consensus estimates.

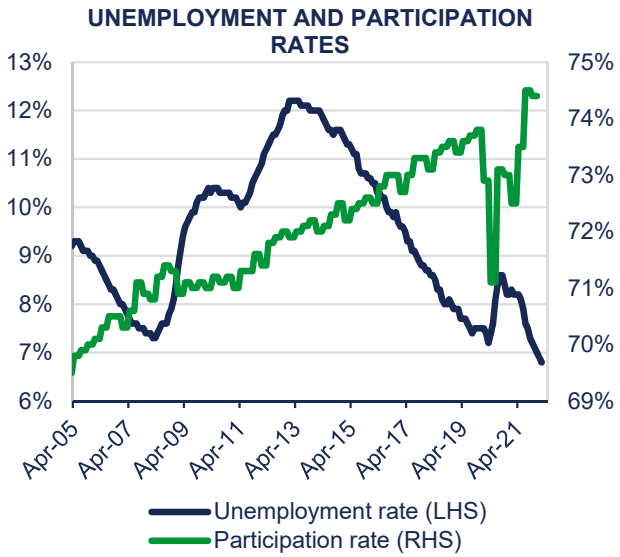
Europe

The war has SAPPED CONSUMER CONFIDENCE.



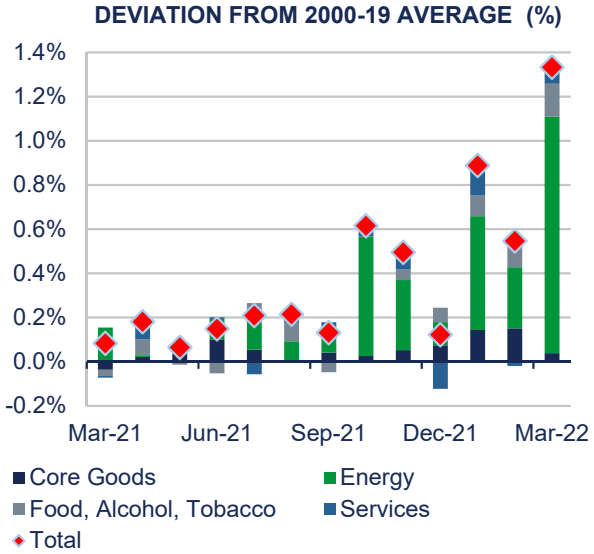
- Consumer confidence staged its biggest drop since the Global Financial Crisis.
- Intentions to purchase big-ticket items plunged, while fear of losing employment deteriorated suddenly in March.
- The war outbreak clearly offset the confidence-improving reopening that was taking place after the latest Covid wave

LABOR MARKETS remain very strong.



- The participation rate is running at its highest level since the birth of the euro, and unemployment is the lowest it has ever been since then.
- This, together with savings accumulation during the pandemic, provides good buffers to euro area consumers. For now, they remain able to at least partially withstand the blow coming from the energy price shock.

Looking ahead, the ENERGY SHOCK will hurt consumption and growth.



- We expect consumption to slow sharply in the months ahead as the energy shock is simply too big not to impact demand and activity.
- While some inflation components are running slightly above their long-term averages, most of the inflation surge in the euro area is explained by the rise in energy prices.
- This will reduce households' purchasing power, leading to belt-tightening (for details, see Monthly Spotlight on page 10).

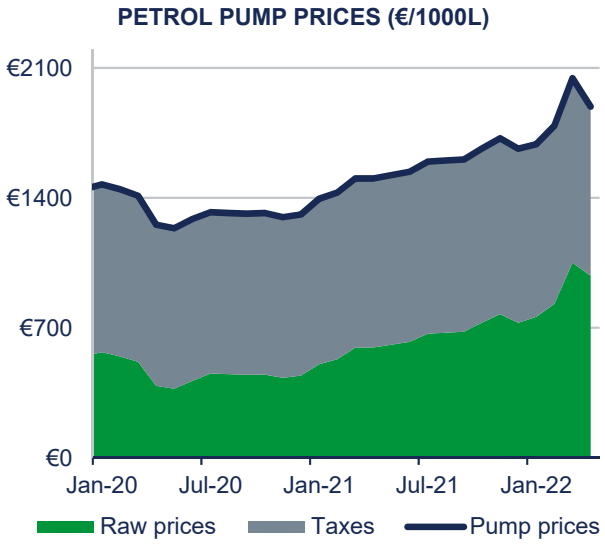
Source: Bloomberg and Haver. As of April 22, 2022.

Europe

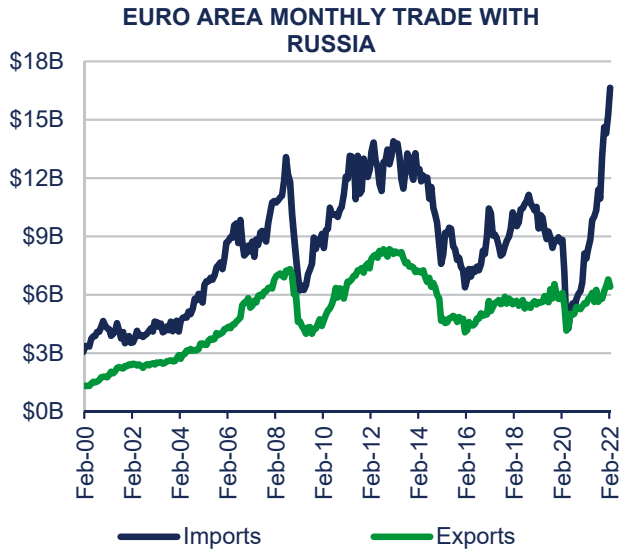
FISCAL POLICY will help cushion at least partly the blow to incomes and prices.

The NEW GEOPOLITICAL ORDER ARISING is likely to trigger persistent inflation pressure.

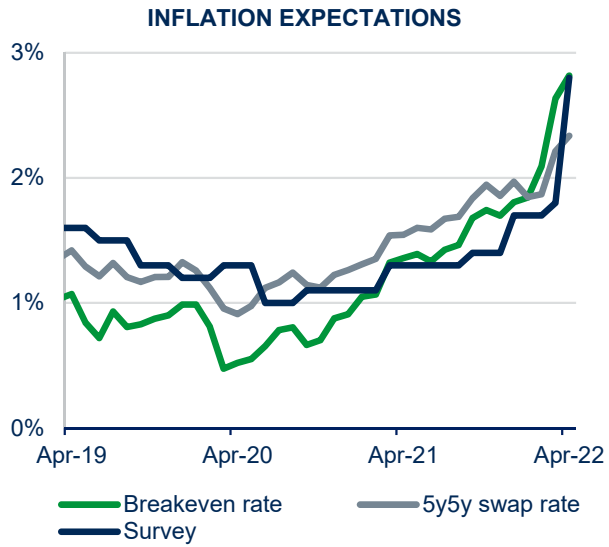
In light of the uncertainty, MONETARY POLICY tightening will be more gradual and data-dependent than markets assume.



- Governments are announcing tax cuts and subsidies to reduce energy bills and gas prices at the pump.
- So far, new fiscal support amounts to 1-2% of GDP, depending on the country.
- They should help mitigate inflation by pushing energy retail prices down, offsetting only a small part of the total increase. They will also cushion the downturn in demand, avoiding recession all else being constant.



- Euro area inflation is being driven by temporary COVID disruptions as well as new trends, which may persist.
- If Europe wants to become independent from Russian commodity imports, it will need massive investment in renewables and rerouting of established supply chains. This will be costly and keep pressures on costs, and thus prices, in the coming years.
- It is sadly ironic that imports from Russia hit a record high on the eve of the war.



- The more persistent nature of inflation is creeping into expectations. These started moving up recently, as the ECB noted in its April press conference.
- It will want to thread the needle and tighten policy gradually to anchor expectations without causing a recession. The economy is already decelerating under the impact of inflation.
- We expect the ECB to remain cautious and hike rates fewer than the five times that markets have priced in for the next 12 months.

Source: Bloomberg and Haver. As of April 2022.

CONSENSUS FORECAST

- We reduced our above-consensus forecast for 2022 euro area growth in the March dashboard due to the war in Ukraine. We maintain it this month at 2%, below consensus (2.8%), because we believe Europe will pay the price of tougher sanctions on Russia. We expect the amount of fiscal support to somewhat soften the blow to private demand from the energy shock. In our alternative scenario where no boycott of Russian imports is implemented, growth would rise to 3.5%, above current consensus.

Economic Growth	4/25/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
EZ Real GDP (Y/Y %)	4.7	1.6	-6.4	5.4	2.8 ▼	2.4 ▼
U.K. Real GDP (Y/Y %)	6.6	1.7	-9.3	7.5	3.8 ▼	1.6 ▼
Inflation						
EZ CPI (Y/Y %)	7.4	1.2	0.3	2.6	6.5 ▲	2.4 ▲
U.K. CPI (Y/Y %)	7.0	1.8	0.9	2.6	7.1 ▲	3.3 ▲
Labor Market						
EZ Unemployment (%)	6.8	7.6	8.0	7.7	6.9 ▼	6.9 --
U.K. Unemployment (%)	3.8	3.8	4.4	4.6	4.0 --	4.0 ▲
Rates						
EZ Central Bank	0.00	0.00	0.00	0.00	0.15 ▲	0.70 ▲
EZ 2Y Note	0.23	-0.61	-0.72	-0.64	0.12 ▲	0.44 ▲
EZ 10Y Bond	0.90	-0.19	-0.57	-0.18	0.67 ▲	0.96 ▲
U.K. Central Bank	0.75	0.75	0.10	0.25	1.25 ▲	1.55 ▲
U.K. 2Y Gilts	1.63	0.53	-0.17	0.66	1.57 ▲	1.64 ▲
U.K. 10Y Gilts	1.92	0.82	0.19	0.97	1.78 ▲	1.94 ▲
Currencies						
EUR/USD	1.07	1.12	1.22	1.14	1.13 ▼	1.15 ▼
GBP/USD	1.27	1.33	1.37	1.35	1.34 ▼	1.37 ▼

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of April 25, 2022. (E)—Bloomberg private market consensus estimates.

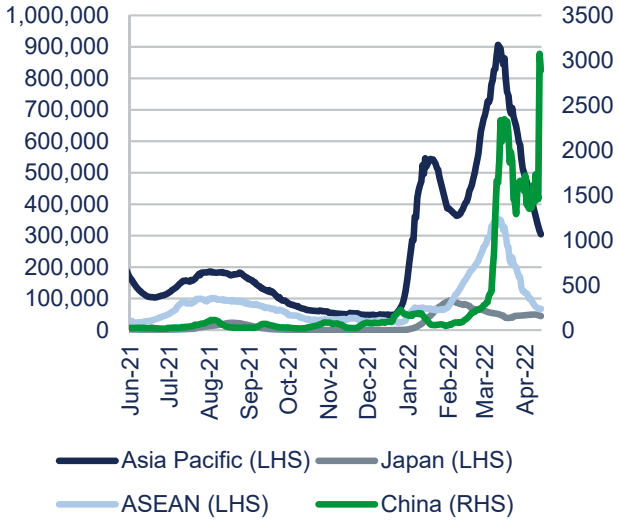
Asia Pacific

COVID has become a renewed risk for China, while it moderates everywhere else.

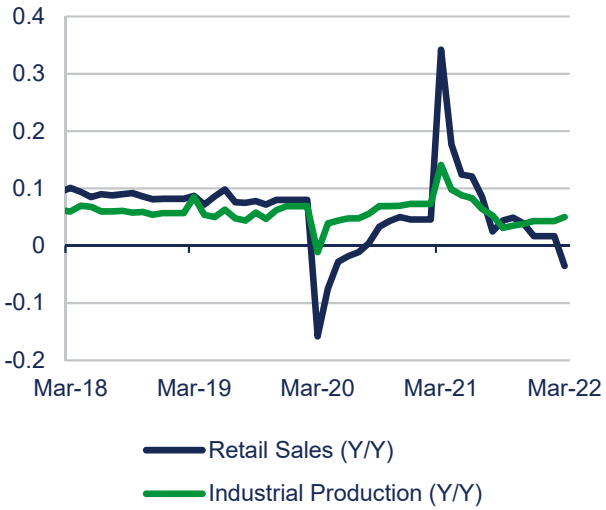
It will impact activity but could weigh on CONSUMPTION more than PRODUCTION…

…as supportive fiscal policies keep INVESTMENT steady.

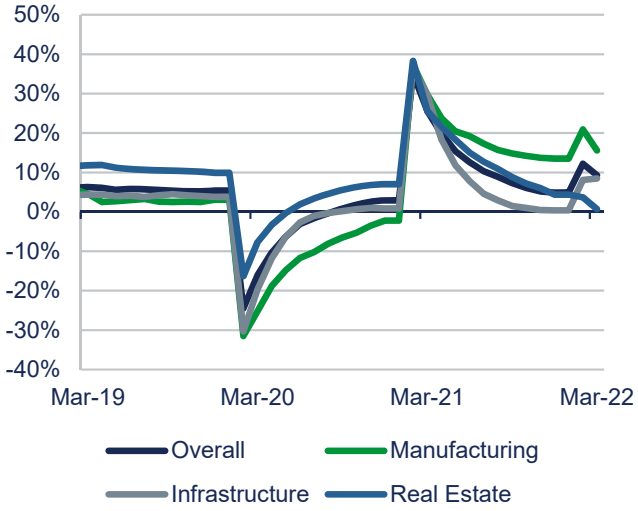
7-DAY AVERAGE DAILY NEW COVID CASES



CHINA CONSUMPTION & PRODUCTION



CHINA FIXED ASSET INVESTMENT Y/Y GROWTH



- Driven by the more-contagious Omicron variant, cases have surged in China, leading to renewed restrictions and lockdowns.
- Authorities are sticking to the zero-COVID approach given the lack of immunity conferred by either past infections or effective vaccinations.
- Cities with medium- to high-risk districts total about 20% of GDP.

- The impact on consumption has been significant, with risks for further downside depending on additional lockdowns.
- Business closures, particularly in the SME and services spaces, could exacerbate the downside effects and is also unlikely to be offset by tax cuts or rebates.
- Factories have been operational so far, given "closed loop" systems, but there have been reports of logistical delays.

- Fiscal policy will likely be the primary tool to cushion downside risks to growth. Coupled with still-robust manufacturing investment, a pickup in infrastructure investment should help buoy overall capex.
- This will not be a smooth process, however, given existing restrictions on local government debt and more prudent implementation on project spending. Lockdowns also limit policy efficiency.

Source: Bloomberg and Haver. As of April 21, 2022.

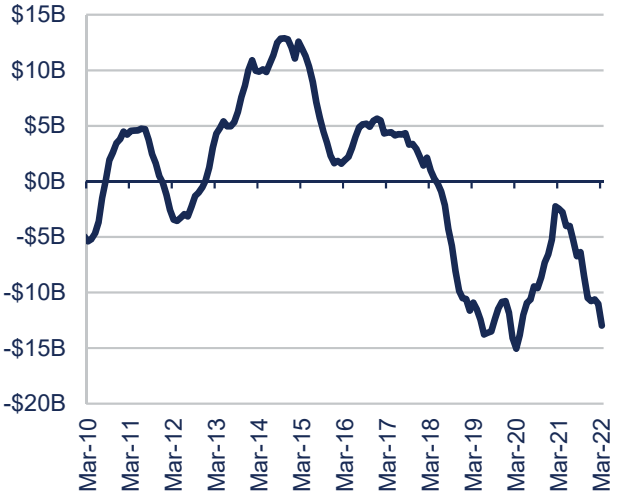
Asia Pacific

China's TRADE RELATIONSHIP with Russia continues to grow.

Meanwhile, MONETARY POLICY remains easy in Japan, but not without cost…

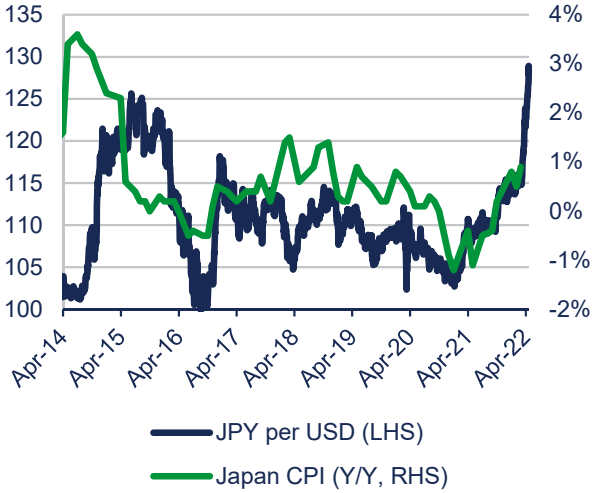
…and continued CENTRAL BANK DIVERGENCE could lead to some unintended consequences.

CHINA TRADE BALANCE: RUSSIA



- China's commodity imports from Russia represent 18% of Russia's commodity exports, up from 5% in 2010.
- Machinery and electronic equipment make up China's largest exports to Russia.
- Chinese authorities intend to continue strengthening strategic coordination with Russia, solidifying its sphere of influence over the region.

JAPANESE YEN & INFLATION



- The yen has depreciated about 10% against the dollar year-to-date. Yield curve control amid rising inflation meant FX is the only channel to adjust.
- A weakening yen should help re-anchor inflation expectations higher, which is the BOJ's stated goal.
- But, the BOJ is in a difficult position and could drop yield curve control if inflation or depreciation become too growth-negative.

FOREIGN HOLDINGS OF U.S. TREASURY SECURITIES

- With both the PBOC and BOJ focused on easy monetary policy, currency weakness will likely prevail.
- This could weigh on domestic investor sentiment for holding U.S. treasury securities, and, coupled with geopolitical considerations, could point to a weaker bid for treasuries and higher yields in the future.

Source: Bloomberg, Haver and Goldman Sachs. As of April 21, 2022.

CONSENSUS FORECAST

- We expect below-consensus 2022 growth in Japan amid the commodity price shock hurting the already-delayed consumption recovery. A combination of higher energy and food prices, together with weaker FX, will likely lead to sticker inflation as well.
- We remain cautious on 2022 growth in China, where we are below consensus, but expect supportive monetary and fiscal policy to help cushion downside risks from external shocks. Upside risks to inflation are also possible given China's exposure to food.

Economic Growth	4/25/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
Japan Real GDP (Y/Y %)	0.4	-0.2	-4.5	1.9	2.1 ▼	1.8 ▲
China Real GDP (Y/Y %)	4.8	6.0	2.2	8.1	5.0 ▼	5.2 --
Inflation						
Japan CPI (Y/Y %)	1.2	0.5	0.0	-0.3	1.5 ▲	0.9 ▲
China CPI (Y/Y %)	1.5	2.9	2.5	0.9	2.2 --	2.3 ▲
Labor Market						
Japan Unemployment (%)	2.7	2.4	2.8	2.8	2.7 --	2.5 --
China Unemployment (%)	4.0	3.6	4.2	4.0	3.9 --	3.8 ▼
Rates						
Japan Central Bank	-0.10	-0.10	-0.10	-0.10	0.00 --	0.00 --
Japan 2Y Note	-0.06	-0.13	-0.13	-0.09	-0.03 ▲	-0.03 --
Japan 10Y Bond	0.24	-0.02	0.02	0.07	0.22 ▲	0.26 ▲
China Central Bank	4.35	4.35	4.35	4.35	4.30 --	4.30 --
China 2Y Note	2.27	2.63	2.71	2.36	2.59 ▲	2.38 ▲
China 10Y Bond	2.82	3.13	3.14	2.77	2.78 ▼	2.89 ▼
Currencies						
USD/JPY	128.23	108.61	103.25	115.08	120.00 ▲	119.00 ▲
USD/CNY	6.49	6.98	6.52	6.38	6.45 --	6.30 ▼

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of April 25, 2022. (E)—Bloomberg private market consensus estimates.

Central Scenario: Stagflation Shock

STAGFLATION SHOCK (50% ODDS)

Inflation rages on. This is a commodities shock for the history books. Pipelines may get disrupted or there is an embargo on Russian energy. Central banks tighten aggressively to reign in inflation expectations. The adverse growth impact on Europe is much stronger than in the U.S., given energy dependence. With inflation far above target and aggressive policy tightening, Europe risks a recession while the U.S. faces a serious slowdown.

After the invasion of Ukraine, appeasement with President Vladimir Putin ceases to be a pursuable policy. **A complete embargo of Russian energy exports** is envisaged by European, U.S., and allied countries, and harsh sanctions are implemented. Russia may cut exports of a number of commodities, too.

This comes at a dear cost, with energy prices surging to unseen levels. This may plunge the overexposed EU economies into a recession with elevated inflation. The U.S. is less exposed thanks to its energy quasi-independence and smaller relevance of trade with Russia. However, its economy also slows down, as the energy shock and inflation hits consumer purchasing power and confidence. The Fed hikes repeatedly to maintain credibility and manage inflation expectations.

Yet, central banks tighten less than double-digit inflation rates would require. They see through some of the energy-induced acceleration of prices, given uncertainty from the war. Except in the U.S., where inflation was already broad-based before the war, policy rates are raised gradually and full quantitative tightening delayed. Compared to war, higher inflation becomes a lesser evil and is tolerated.

Slowing global growth, surging inflation, and rising policy rates prove a hardly digestible mix for emerging markets. Big commodity exporters see the blow to their economies softened by improving terms of trade, current account balances, and appreciating currencies. For other EMs, the going gets tough, and financial instability could arise in the most vulnerable ones. Social unrest could easily flare-up in countries where food and energy represent a major portion of day-to-day expenditures.

U.S. Treasuries: 10Y settling at 2.5% over 12-18 months

The curve first sells off at all maturities and bear flattens, as evidence of demand being hurt and the economy slowing down emerges, the curve shifts down, with the 10Y settling at 1.5% over 12-18 months.

Conditions

- Full embargo on Russian energy exports or similarly harsh set of sanctions
- Prolonged war in Ukraine

Indicators

- Dwindling consumer confidence and expenditures
- Further inflation acceleration globally
- Falling PMIs

Scenario risks

- Quick resolution of the conflict
- Complete change of the policy toolbox

Alternative Scenario: Higher for Longer

HIGHER FOR LONGER (40% ODDS)

Economic growth remains above-trend in advanced economies but the energy shock keeps inflation from slowing down until year-end. Central banks tighten financial conditions too gradually and have little impact. Household strength provides firms with pricing power to pass-through higher input costs. Banks have space to lend and help the economy buffer rising inflation. Growth remains above-trend while inflation stays higher for longer.

The invasion of Ukraine creates a continuing humanitarian tragedy and another massive inflation shock. It has shattered the equilibrium prevailing in Europe since the fall of the Berlin Wall and **presents politicians across Europe with a stark choice: recession or appeasement of Putin's regime.**

Balking at the consequence of a full ban on Russian energy exports on which Europe grew dependent, politicians choose appeasement and, albeit introducing some harsh sanctions, steer clear of a full energy ban. **Energy prices and headline inflation stabilize but are prevented from slowing down in the second half of the year.**

Households saved a large share of their fiscal payouts in 2021 and have become less sensitive to prices. **In the U.S., the consumption boom continues; elsewhere it shows resilience.**

Central banks tighten financial conditions but very gradually – potentially too gradually. Supply-side disruptions related to COVID and the war continue to exert inflation pressures that central banks are not equipped to control.

Higher inflation, and a significant policy tightening, set conditions for a serious slowdown. Beyond the horizon of this scenario, recession is a risk.

U.S. Treasuries: 6% over 12-18 months, with curve steepening

Conditions
- No full energy embargo on Russia
- Resolution of the Ukraine conflict
- Accommodative central banks

Indicators
- Geopolitics
- Central bank speech
- Inflation expectations and wages
- Solid consumer confidence and expenditures

Scenario risks
- Confidence hit from the war and/or energy shock
- Brutal central bank reaction

The above represent the views of Barings as of April 26, 2022, and are subject to change at any time. These predictions may not come to fruition.

Alternative Scenario: A Fine Balance

A FINE BALANCE (10% ODDS)

Inflation accelerates again on the back of sanctions against Russia and higher energy prices. Central banks, having to face an even more complex trade-off between a slowdown and accelerating inflation, respond cautiously. They start the necessary tightening in baby steps. The war de-escalates and inflation starts trending down in the second half of the year, proving central banks right and allowing for a smooth normalization.

As Europe, the U.S., and Japan react to the invasion of Ukraine, harsh sanctions are imposed and this, together with the fear that these could escalate to a full embargo of Russian energy exports, pushes energy commodities prices higher. Coming on top of continuing disruptions to supply chains, **inflation persists from a demand for goods in excess of what global factories can produce and increased costs of energy.**

Central banks are however even more wary of stifling growth now that a major energy shock may hit their economies and thus prefer to take the risk of higher inflation over that of a recession. They are proven right, as the situation in Ukraine thankfully does not develop into an attrition war, trade resumes, and prices of main commodities normalize.

Higher energy prices and heightened uncertainty reduces consumer confidence and investment intensions, provoking **a slowdown in demand and rewarding central banks' prudence and patience with the much-awaited slowdown in prices.**

U.S. Treasuries: 2.5% over 12-18 months with curve steepening

Conditions

- Harsh sanctions but no embargo on Russian energy exports
- Underlying growth dynamics not significantly affected by the war

Indicators to watch

- Developments in Ukraine
- Sanctions

Scenario risks

- Worsening geopolitical risks

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As of March 31, 2022.

Important Information

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