BARINGS INVESTMENT INSTITUTE

June 2022

The Path From the Peak

MACRO DASHBOARD

BARINGS

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June Outlook – The Path From the Peak

For much of the last decade, every time market sentiment soured as much as it has this year, investors found glimmers of hope and answered calls to “buy the dip.” Not this time. Certainly, reasons to worry abound. The enduring war in Ukraine, the global energy and food crises, the cracks appearing on the Chinese economy, and the persistent inflation data all suggest things can only get worse.

This may be true, but GDP growth, employment levels, industrial production, and other key measures of economic activity are close to decade-highs in most major jurisdictions. When you have reached the peak of the mountain, you can only go down the other side. The question is, how fast and steep will the path ahead be?

We see the highest odds, as much as 50%, of the descent being steep, on the back of aggressive central bank tightening and declining purchasing power in a stubbornly high inflation scenario. A **Stagflation Shock** will hit the global economy. Supportive fiscal policy, low unemployment, and healthy corporate earnings may help limit some of the damage, but Europe looks to be headed for a recession, even if the U.S. may avoid one.

In many ways, the strength of growth is in consumers’ hands. It's possible that, even with higher prices, they may continue spending extra savings accumulated during the pandemic, safeguarding growth against all odds. We attach a 20% probability of this happening. Such a scenario would be even more challenging for central banks as the tightening they deliver may prove too little, too late and inflation remains **Higher for Longer**. While growth remains solid in this scenario, it may prove to be the swan song for the Great Moderation era, causing bigger problems down the road as inflation becomes entrenched and central bank credibility crumbles. Significant financial instability may follow.

A recession could also develop without aggressive monetary policy. Should worries mount enough to convince households and firms to postpone their spending and investment plans, demand could cool faster than expected. Normalizing supply chains could prove a mixed blessing as goods return to store shelves just as demand waivers. A **Steeper Slide** will likely ensue, with growth and inflation falling in tandem. Central banks stop hiking rates and may have to change direction quickly. We attach a 30% probability to this scenario.

While the headwinds are global, the tailwinds differ in their regional strength. In the U.S., the savings rate dipped to the lowest since 2007, but plenty of savings still bless richer households that are happy to spend them. Things could change fast, but months of plummeting consumer confidence have yet to translate into belt-tightening. Corporates are cash-rich, too. A U.S. slowdown may well materialize, but a recession is far from a foregone conclusion.

Some period of negative growth is more probable in Europe, where wages and savings grew much less than in the U.S. Exposed to harsher energy shocks, Europe may enjoy the post-COVID reopening and a solid tourist season but, once these ebb, structural shifts such as the reorientation of production away from Russia and the green transition will impose costs. It could be well after the ECB has started tighten aggressively.

Policymakers seem to be more in control in Asia but with unclear effects. President Xi Jinping’s unrelenting zero-COVID policy is taking its toll on China's growth, leaving it an unlikely candidate to drive any global recovery. For once, the good news comes from Japan, where inflation will never be scary and the pandemic is finally ending.

Staring down from the peak, the path looks scenic—and a little treacherous.

- Matteo Cominetta

Barings Investment Institute Scenarios for the Next 12-18 Months

STEEPER SLIDE (30%)

- **High inflation** cuts into purchasing power and markets price in tight financial conditions. Weakening sentiment and demand make the large inventories that firms have accumulated for the post-pandemic boom excessive.
- **China's continuing pandemic battle** delivers much weaker-than-targeted growth, contributing to a sharp global slowdown.
- **Central banks raise rates** in an attempt to tame inflation, but it proves too much given underlying weakness.
- The U.S. economy slides into recession as demand falls. After several hikes, **central banks return to easing toward the end of the scenario horizon**.
- **Policy Hikes:** Fed Funds Rate to 2.5%
- **10-Year U.S. Treasuries**: **2%** with curve **inverting** in the process
- **Market Implications**: Supportive of government bonds and IG credit. Negative for equities.

HIGHER FOR LONGER (20%)

- **The oil shock** adds to lingering labor shortages and the green transition at a time of continuing commodity shortages.
- **Household strength**, however, gives firms 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. They may be forced into more radical action in late 2023, but growth remains healthy until then.
- **Growth remains above-trend while inflation stays higher for longer**.
- **Policy Hikes:** Fed Funds Rate to 4.5%
- **10-Year U.S. Treasuries**: **6%** as the **curve steepens**
- **Market Implications**: Supportive of financials, 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, and pressures continue as the world adjusts to the consequences of Russian sanctions.
- **Central banks tighten aggressively** to rein in inflation expectations.
- **Demand is destroyed,** hammered by inflation and tighter financing conditions. **The adverse growth impact** on Europe is much stronger than 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:** Fed Funds Rate to 3%
- **10-Year U.S. Treasuries**: Settle at **2.5%** in 12-18 months, after the curve first sells off across all maturities and **bear flattens**
- **Market Implications**: Protracted period of volatility. Supportive of USD, TIPS, gold, floating rates. Negative risk and duration.

Scenario Matrix—Economy

		Scenarios						
		*Steeper Slide**		*Higher for Longer*		*Stagflation Shock*		
	Annual Averages	**2022**	**2023**	**2022**	**2023**	**2022**	**2023**	**Baseline scenario**
U.S.	Growth	2.5%	0%	3.5%*	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	5%	3%	8%*	6%*	7%	5%	
	Unemployment	4%	6%	3%	3%	3.5%	4.5%	
Euro Area	Growth	2.5%	-1%	3.5%	2.5%	2%	-1%	Uncertainty about the **energy price shock** and its policy response 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	6%	2%	7%	3%	8%	4%	
	Unemployment	7%	10%	6%	8%	7%	10%	
Japan	Growth	1.5%	0%	2.5%	2%	1.5%	1%	A combination of **higher commodity prices and weaker FX** is likely to lead to stickier inflation. Existing supply chain disruptions and exposure to China are significant downside risks.*
	Inflation	2%	1%	2%*	2%*	2%	1.5%*	
	Unemployment	3%	4%	2.5%	2.5%	3%	3.5%	
China	Growth	2%	4%	5%	5%	4%*	4.5%	Focus will be on **whether monetary and fiscal policy** cushions downside risks, as "bazooka" stimulus is unlikely. With China's zero-COVID policy unlikely to lift before the fall, growth is expected to come in below target.*
	Inflation	2%	3%	2.5%	2.5%	3%	3%	
	Unemployment	5%	4%	3.5%	3.5%	4%	4.5%	

The above represent the views of Barings as of June 1, 2022, and are subject to change at any time. These predictions may not come to fruition.
Notations: Asterisks indicate updated estimates from the last publication.

Scenario Matrix—Central Bank Policy

	Scenarios		
Central Bank	***Steeper Slide****	***Higher for Longer***	***Stagflation Shock***
FED	Fed Funds Rate: 2.5% The Fed winds down its balance sheet and front-loads rate hikes. However, as growth slows faster-than-expected, the Fed must pause and start easing	Fed Funds Rate: 4.5% Higher, stickier inflation takes hold as demand proves resilient. The Fed does not tighten enough through next year	Fed Funds Rate: 3% The energy shock causes a surge in inflation, and, following liftoff that began in March, the Fed's current tightening brings inflation under control
ECB	the ECB bring interest rates to 0 in 2022 and is then forced to stop as growth and inflation falter	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 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 normalizes to 0 in 2023; yield curve control (YCC) is unwound as inflation responds to the FX channel*	Policy rate stays negative; inflation surprises or excessive yen depreciation could see YCC bands widen 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 June 1, 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	***Steeper Slide****	***Higher for Longer***	***Stagflation Shock***
Rates	10Y UST around 2%; curve flattens or inverts	10Y UST settles at 6%, led by breakevens; curve 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	Supportive duration, negative for high yield	Negative duration, positive credit amid robust economic growth	Negative duration
Equities	Negative risk assets and supportive quality	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 safe haven call	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 slowdown should reduce the pressure	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 June 1, 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 May

WHAT'S NEW

- **Hawkish Fed pivot** leads markets to price in 50bp hikes in the next couple of meetings
- With much anticipation and uncertainty, the Fed's **Quantitative Tightening** has finally begun
- The **ECB** moves to tighten, too, as Europe cuts oil imports
- **The euro area** maintains the escape clause on strict fiscal rules
- **COVID** is improving and restrictions unwinding, particularly in Japan
- **China** lockdowns ease, but zero-COVID policy shows few signs of relaxation

WHAT WE LEARNED

- **The Fed is beginning to stress price control over growth**, looking for further tightening of financial conditions
- **There is a structural change to Europe's approach in using fiscal policy** as a tool for macro stabilization in times of duress
- **China is more concerned with controlling health risks** than reaching growth target and still reluctant to deploy massive support measures

WHAT WE ARE HEARING FROM OUR TEAMS

- Rising concern about **slower growth in China**, even as lockdowns ease
- **Oil market squeeze** may push prices to new highs
- **Markets begin pricing in recession**, reducing duration risk temporarily
- Company analysts see **widespread increases in input costs**, which could weigh on margins as growth slows

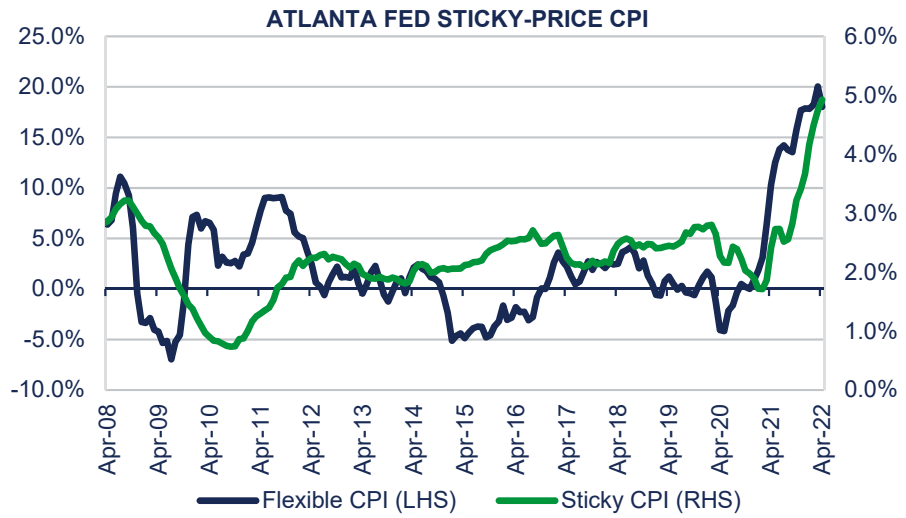
WHAT WE ARE WATCHING

- **Food prices and unrest in EMs**
- **U.S. wage growth**
- **Consumer response** to higher inflation, tighter monetary policy, and greater uncertainty
- Impacts of **lingering commodities shock** to the real economy and financial markets

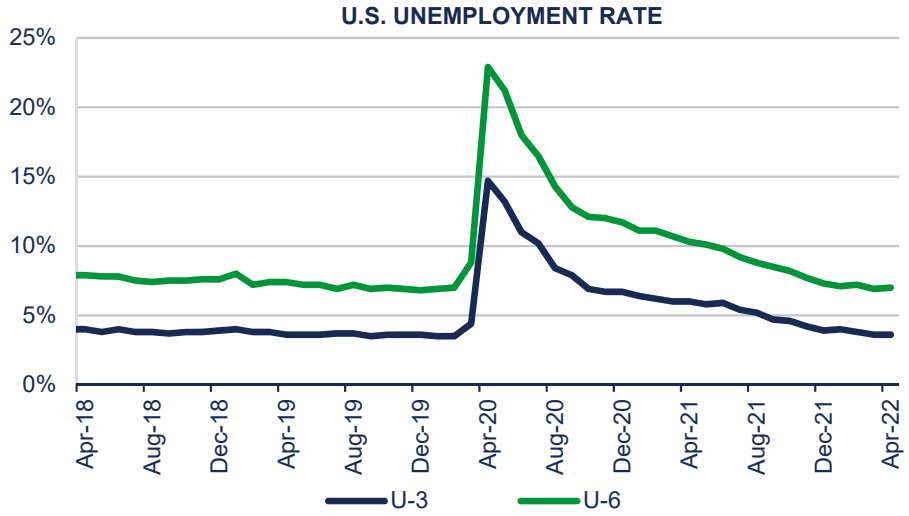
Fed Radar Screen: Inflation Indicator Watch

Inflation is elevated and broad-based, exacerbated by the war in Ukraine. Together with a tight labor market and rising nominal wages, this suggests the FOMC will hike 50bps at the next couple of meetings.

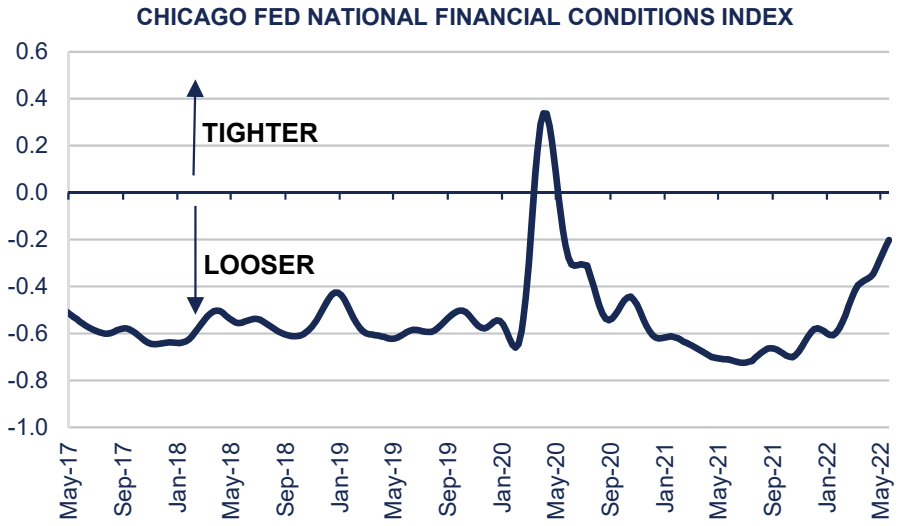
INFLATION: CONCERN



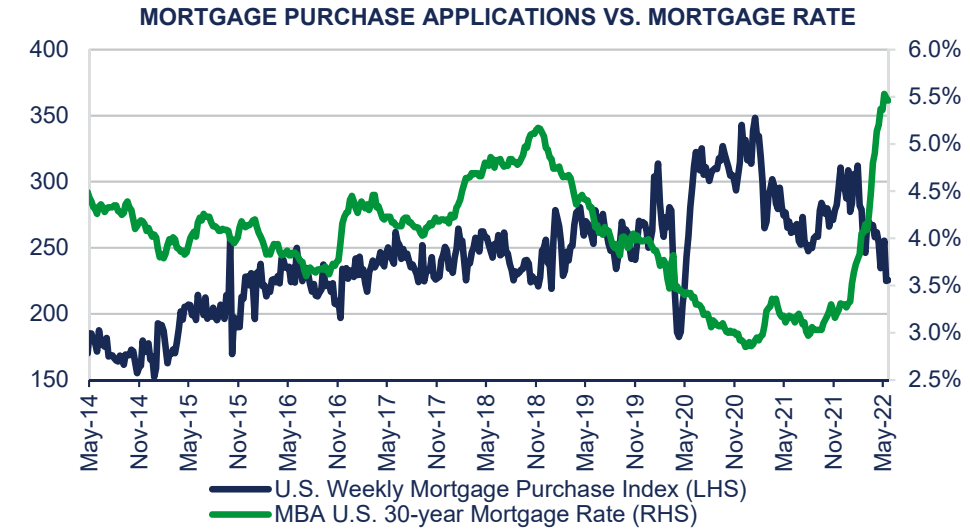
EMPLOYMENT: CONCERN



FINANCIAL CONDITIONS: MODERATING

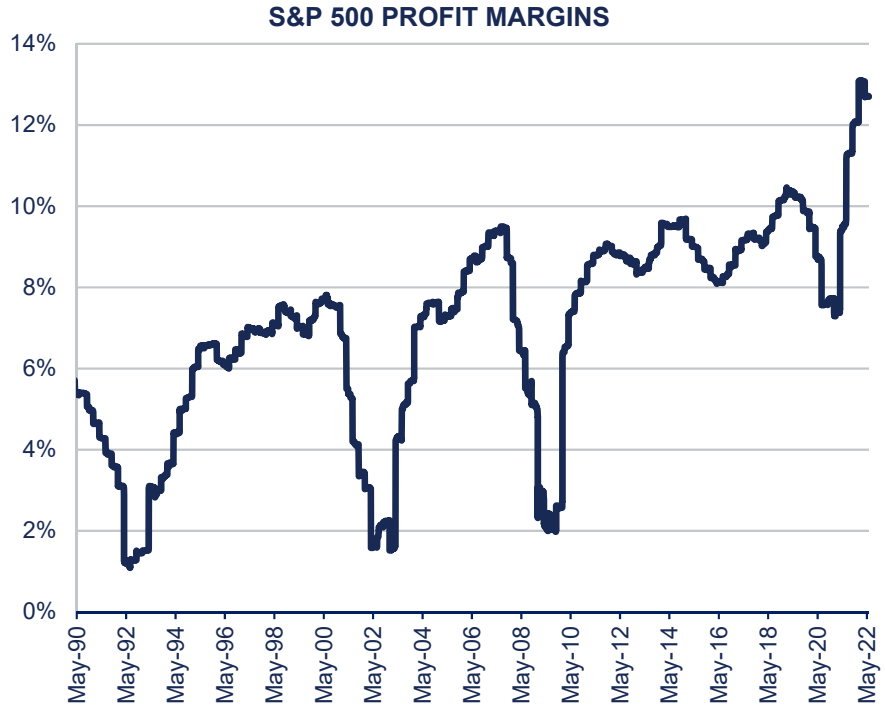


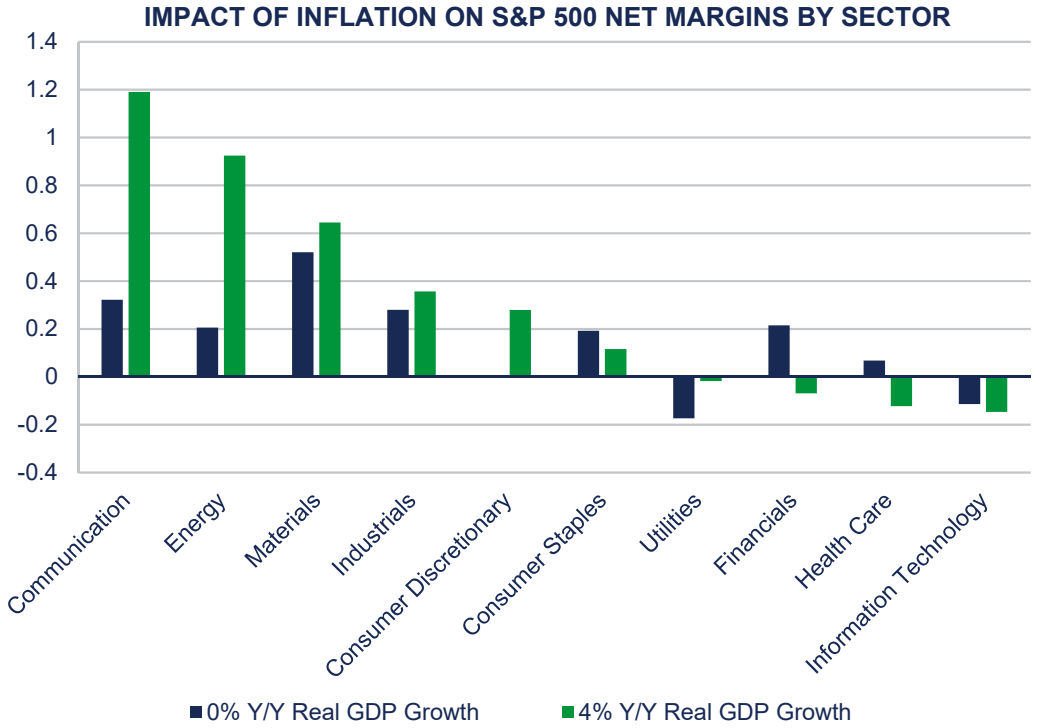
HOUSING MARKET: MODERATING



Source: Bloomberg and Haver. As of May 31, 2022.

Monthly Spotlight: When and Where Will High Inflation Weigh on Margins?





So far, healthy U.S. consumer balance sheets have allowed overall S&P 500 net margins to reach a record high. However, what protects companies hurts consumers, and with risks to consumer spending and growth mounting, something has to give. We look to the historical performance of S&P 500 profit margins to understand what the impact of this trade-off may be in different growth and inflation regimes.

A regression analysis utilizing data on net profit margins from 2002 to 2019 for the S&P 500 index shows that, ceteris paribus, **when real GDP growth is above 3% Y/Y, rising inflation does not hurt net margins**. This is because a booming economy is good for profit margins, as it likely gives firms room to pass on higher prices to consumers. Confirming this intuition, we find that **when GDP growth is below 3% Y/Y, higher inflation is associated with lower profit margins**.

Looking at S&P 500 sectors, we find that **some sectors' margins actually increase in high-inflation environments; this is the case for energy, materials, industrials, and consumer staples**. For these sectors, inflation is often driven or accompanied by higher commodity prices, and higher prices for these goods actually boosts revenues more than they increase costs.

When growth is strong, the positive impact of inflation is magnified for the communications, energy, industrial, materials, and consumer discretionary sectors. For all other sectors, we find instead that inflation hurts margins when associated with high growth.

At the other end of the spectrum, **utilities, health care, and IT sectors generally see margins suffer with inflation, irrespective of growth rates**. Click here for more detail.

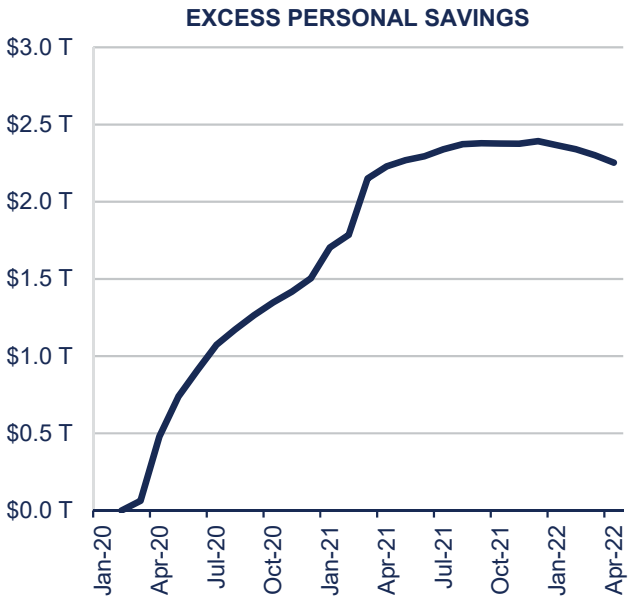
Source: Bloomberg, FactSet, Barings calculations. As of May 31, 2022.

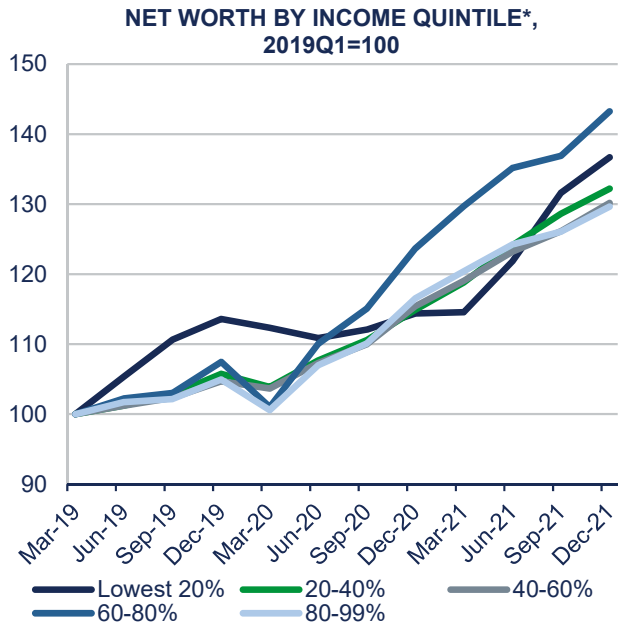
United States

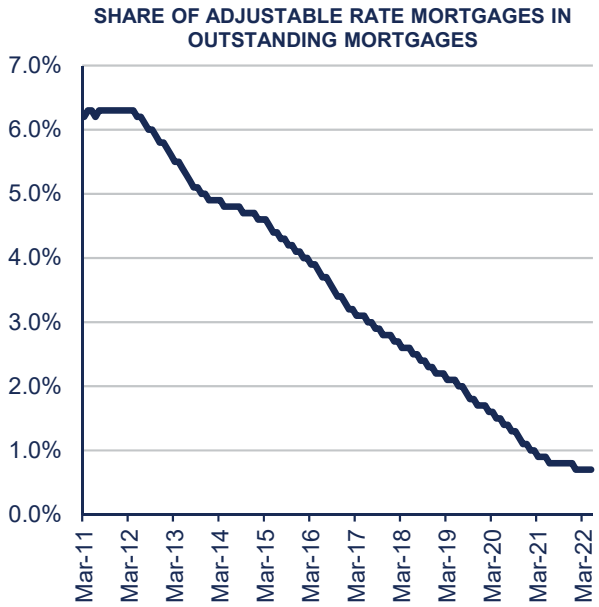
Strong fundamentals will support spending in the near-term, given $2.2 trillion in EXCESS SAVINGS.

Meanwhile, NET WORTH has increased across all income groups.

The impact of rising rates will be a lag to consumers, given a majority of CONSUMER LOANS held at fixed rates.







- Even as consumer sentiment trends lower, real personal spending is strong, 5.6% above pre-COVID levels, supported in part by excess savings.
- Consumers across all but the lowest 20% of income earners still have excess savings. Adjusting for the differing marginal propensities to consume from savings by income group, excess savings could last until June 2023 if the decline follows the average rate so far this year.

- Net worth has increased across all income groups, supported by higher house prices, asset prices, excess savings, and deleveraging by households during the pandemic.
- However, tightening financial conditions should weigh on net worth—particularly among the higher-income groups, which have greater exposure to financial markets.

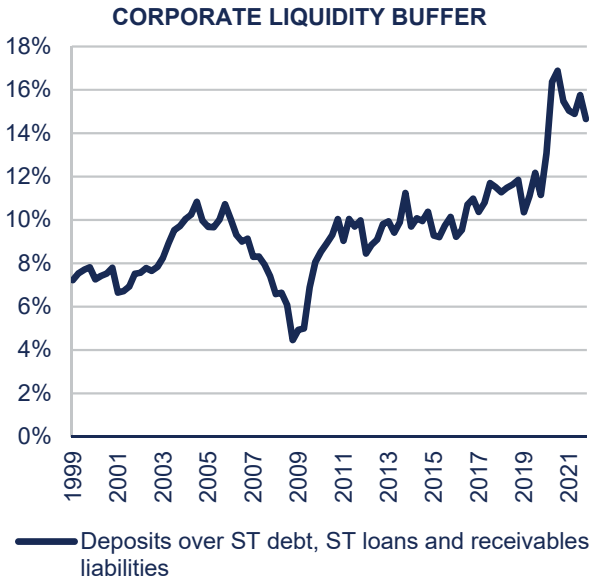
- Most consumer loans are held at fixed rates. Therefore, even though the Fed is set to continue hiking interest rates this year, the impact will be lagged and smaller this year.
- A study by Bank of America estimates that, assuming current market implied rate hikes, on average, debt repayments would rise by about $450-510 per household this year, which is only about 0.3% of disposable income.
- The impact will be larger once these existing loans mature, and households must take on debt with the higher interest rates.

* Average before tax income by quintile: 0-20%: $13,219; 20-40%: $34,550; 40-60%: $59,422; 60-80%: $97,221; Top 20%: $218,191

Source: Haver, Federal Reserve, Bank of America, and Barings calculations. As of May 27, 2022.

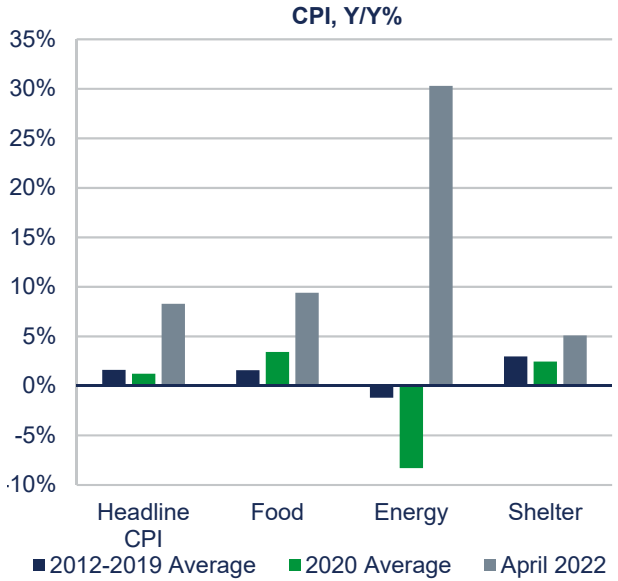
United States

Firms are also in strong positions, with CORPORATE LIQUIDITY BUFFERS elevated historically.



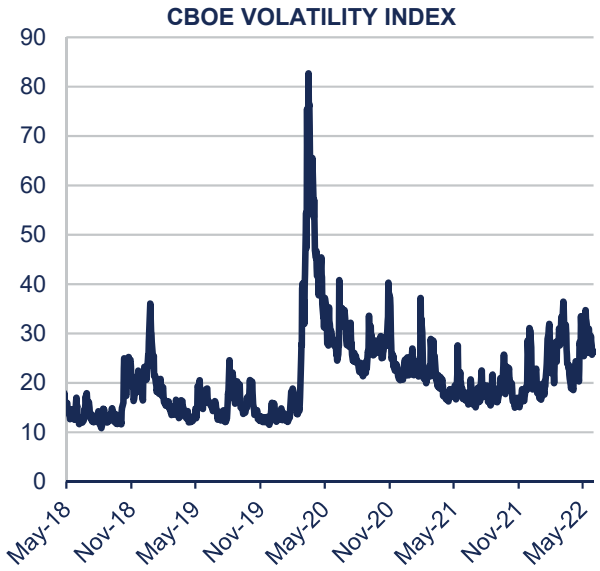
- Corporate liquidity is at high historical highs: even focusing on only the most-liquid assets (bank deposits) these represent a buffer 50% higher than that with which U.S. corporations faced the Global Financial Crisis.
- As growth slows, defaults may tick higher from extremely low levels. However, strong corporate balance sheets should shield against a surge in default rates.

However, there are several headwinds, such as RISING PRICES OF NECESSITIES, that should slow spending growth.



- Prices for necessities are rising fast and, without further policy support, will weigh on discretionary spending.
- However, the impact will be different across income groups, with lower-income households feeling relatively greater pain, given they spend a larger share of real disposable incomes on necessities than higher-income households.

Volatility should remain, given elevated uncertainty and the Fed's further tightening in FINANCIAL CONDITIONS.



- Uncertainty on the economic outlook is extremely elevated and will continue to weigh on financial markets. Moreover, the impact of quantitative tightening could add to market volatility.
- Meanwhile, the Fed is looking for further tightening in financial conditions to help reel in inflation.
- Therefore, while the U.S. may be able to avoid a technical recession through the remainder of our outlook, we expect further tightening in financial conditions.

Source: Bloomberg, Haver, and Barings calculations. As of May 31, 2022.

CONSENSUS FORECAST

- Consensus has downgraded growth and upgraded inflation closer to our baseline outlook for 2022. However, our central scenario continues to call for below-consensus growth and above-consensus inflation in 2023. This is because we see the energy and commodity price shock stemming from the war in Ukraine boosting already-elevated U.S. inflation, 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 in 2023, given expectations for slower growth.

Economic Growth	5/31/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
Real GDP (Y/Y %)	3.5	2.3	-3.4	5.7	2.6 ▼	2.0 ▼
Inflation						
CPI (Y/Y %)	8.3	1.8	1.2	4.7	7.1 ▲	3.0 --
Core PCE (Y/Y %)	4.9	1.7	1.4	3.3	4.6 ▼	2.9 ▲
Labor Market						
Unemployment (%)	3.6	3.7	8.1	5.4	3.6 --	3.5 --
Rates						
Fed Funds	0.88	1.63	0.13	0.13	2.65 ▲	3.10 ▲
2Y Treasury	2.56	1.57	0.12	0.73	3.01 ▲	3.06 ▲
10Y Treasury	2.85	1.92	0.92	1.51	3.09 ▲	3.18 ▲

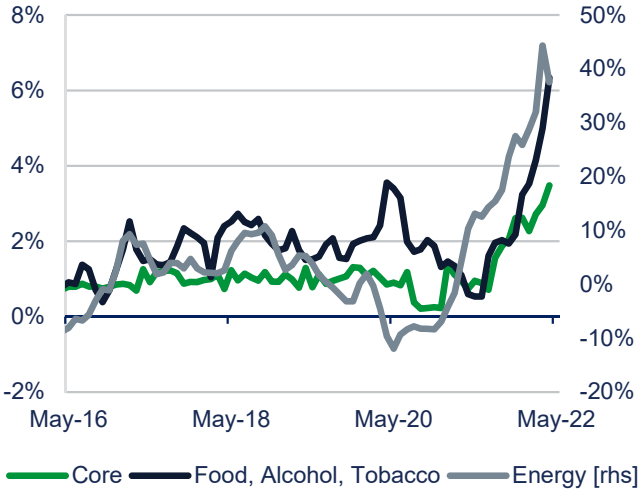
Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of May 31, 2022. (E)—Bloomberg private market consensus estimates.

Europe

INFLATION concerns remain top of the agenda.

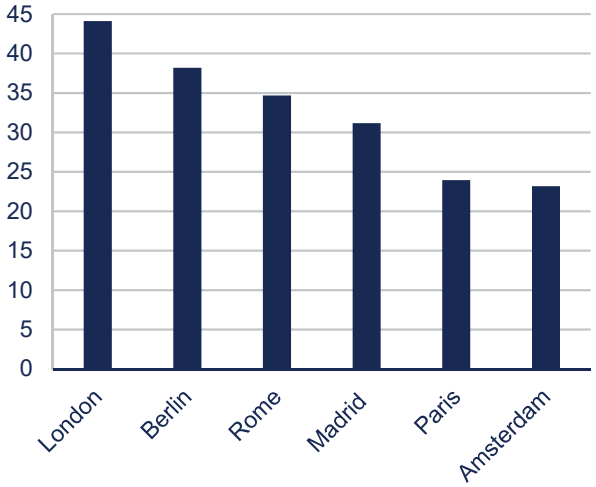
MAIN INFLATION COMPONENTS



- While the top driver is still energy in the euro area, other components have started accelerating, partly the result of war in Ukraine.
- Food inflation is now at multi-decade highs, and there is no sign of respite as wholesale prices continue to run.
- Core inflation, while still a fraction of that in the U.S. or U.K., is also accelerating and hit 3.5% in May.

DEPENDENCE ON RUSSIAN ENERGY will determine economic vulnerability.

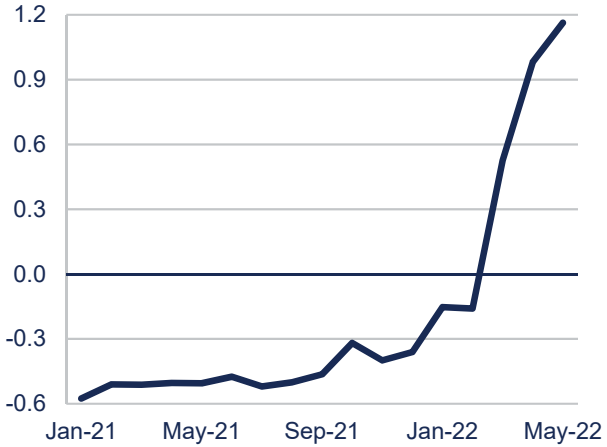
RESIDENTIAL ELECTRICITY PRICE INDEX



- Residential electricity prices in European capitals have risen a staggering 29% Y/Y. Different energy sources and policy responses have generated different increases in energy prices across Europe.
- Government subsidies and tax cuts reduced prices over the last two months, but these were more than offset by wholesale price increases.
- Countries most reliant on gas for electricity generation (Germany and Italy) and those with no active government policies (the U.K.) are the most vulnerable to further escalation in the Ukraine crisis.

Markets are convinced THE ECB will be very aggressive.

EXPECTED ECB POLICY RATE BY YEAR END (%)

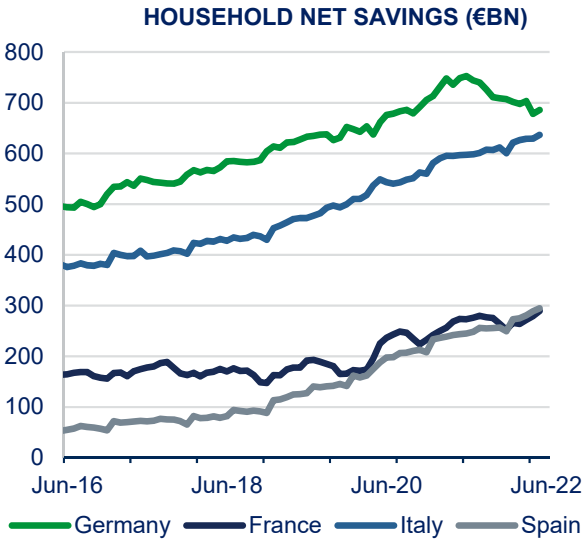


- The war has clearly shifted ECB forward guidance and market expectations of policy changes towards the hawkish side.
- While markets expected between one and two 25bp hikes by year end at the eve of Russia's invasion, they are now pricing slightly more than four.
- Given the supply-side nature of the inflation shock, the ECB will watch the longer term. It will remain data dependent, and policy action will depend on the persistence of the oil shock.

Source: Bloomberg and Haver. As of May 30, 2022.

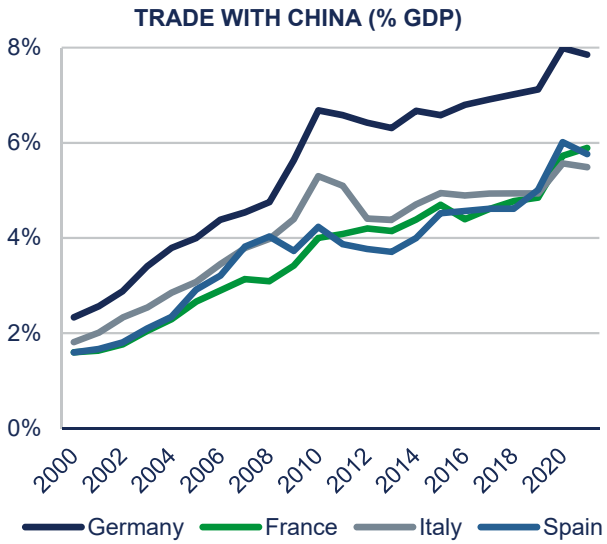
Europe

CONSUMER BALANCE SHEETS could sustain some tightening.



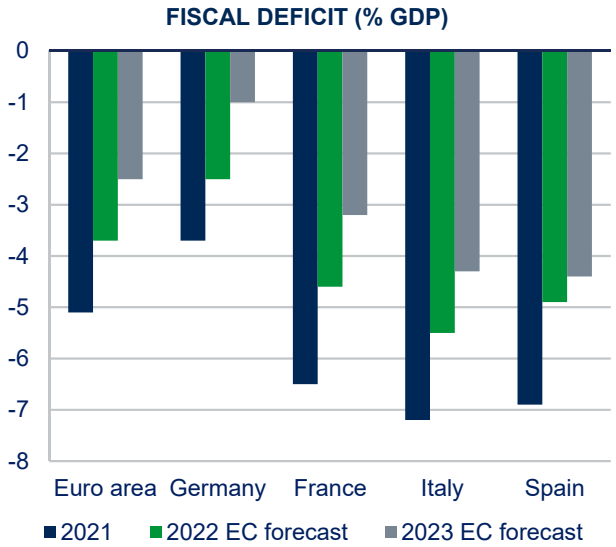
- Consumer balance sheets suggest savings grew little during the pandemic but started from a high base. Wages remain subdued, however, growing roughly 2% against a 7.5% inflation rate.
- As a result, euro area consumers lost purchasing power but appear shielded by savings buffers and borrowing capacity.
- A sharp increase in bank lending rates could significantly slow the European economy, particularly in times of an oil embargo.

A big unknown is the pace of the recovery in China and the strength in EXTERNAL DEMAND for EU goods.



- Europe has integrated closely with China, with both imports and exports between the two regions rising constantly to reach relevant levels.
- As China's relentless zero-COVID policy takes its toll on both supply and demand, trade will likely decline.
- As a result, external demand weakness could add to internal demand weakness while keeping inflation strong, a purely Stagflationary Shock.

We may be entering a new era of FISCAL SPENDING in the euro area.



- Fiscal policy is likely to offset part of the tightening provided by monetary policy.
- Suspension of the Stability and Growth Pact fiscal rules, announced in late May by the European Commission, is a green light for governments to push ahead with policies shielding vulnerable populations from the energy price shock while speeding up the green transition.
- Budget deficits should remain supportive, testifying to the willingness of national governments to go down that route.

Source: Bloomberg and Haver. As of May 30, 2022.

CONSENSUS FORECAST

- Our expectations of increasingly strict sanctions on Russian energy exports are coming true, which will likely inflict a substantial **Stagflationary Shock** on the euro area. Once beneficial effects of post-COVID reopenings and a solid tourist season fade away, we expect growth to slow markedly, averaging 2% this year and -1% next.

- In our alternative **Higher for Longer** scenario where no further boycott of Russian imports is implemented, growth would rise to 3.5%, above current consensus.

Economic Growth	5/31/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
EZ Real GDP (Y/Y %)	5.1	1.6	-6.4	5.4	2.6 ▼	2.2 ▼
U.K. Real GDP (Y/Y %)	8.7	1.7	-9.3	7.5	3.8 --	1.4 ▼
Inflation						
EZ CPI (Y/Y %)	8.1	1.2	0.3	2.6	6.8 ▲	2.7 ▲
U.K. CPI (Y/Y %)	9.0	1.8	0.9	2.6	7.7 ▲	4.0 ▲
Labor Market						
EZ Unemployment (%)	6.8	7.6	8.0	7.7	6.9 --	6.9 --
U.K. Unemployment (%)	3.7	3.8	4.4	4.6	4.0 --	4.1 ▲
Rates						
EZ Central Bank	0.00	0.00	0.00	0.00	0.45 ▲	1.05 ▲
EZ 2Y Note	0.49	-0.61	-0.72	-0.64	0.44 ▲	0.65 ▲
EZ 10Y Bond	1.12	-0.19	-0.57	-0.18	1.04 ▲	1.20 ▲
U.K. Central Bank	1.00	0.75	0.10	0.25	1.60 ▲	1.70 ▲
U.K. 2Y Gilts	1.57	0.53	-0.17	0.66	1.57 --	1.55 ▼
U.K. 10Y Gilts	2.10	0.82	0.19	0.97	1.87 ▲	1.92 ▼
Currencies						
EUR/USD	1.07	1.12	1.22	1.14	1.10 ▼	1.15 --
GBP/USD	1.26	1.33	1.37	1.35	1.28 ▼	1.33 ▼

Arrows indicate consensus estimate change compared to one month ago

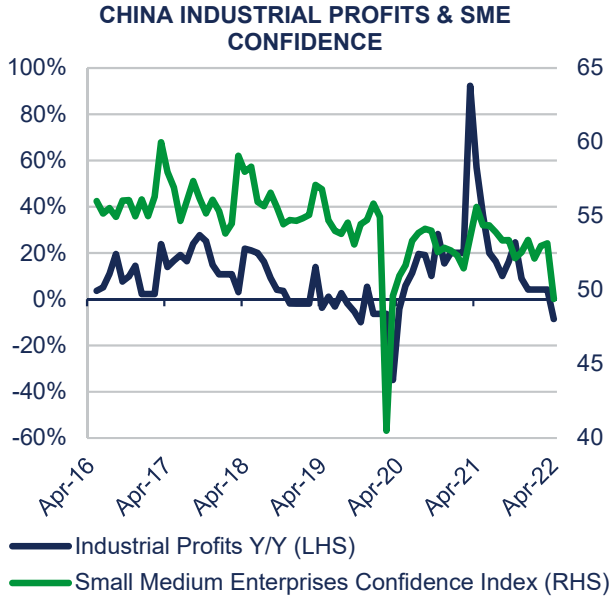
Note: Unemployment figures are annual averages.
Source: Bloomberg. As of May 31, 2022. (E)—Bloomberg private market consensus estimates.

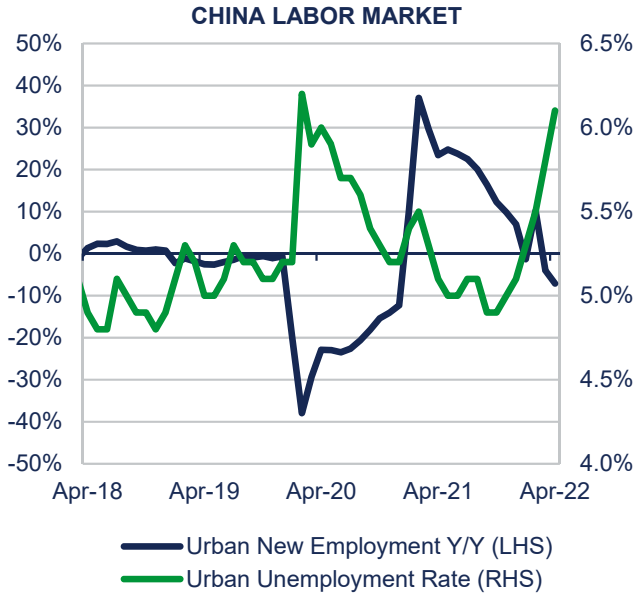
Asia Pacific

The ZERO-COVID POLICY will likely remain until fall and continue to weigh on activity.

BUSINESS SENTIMENT, particularly among smaller enterprises, has deteriorated…

…adding pressure to the LABOR MARKET and the consumer, which is seeing weakening wages and income prospects.





- The latest lockdowns have hit activity more than the previous Delta wave and associated power shortages last year.
- New daily cases are edging lower, leading to a relaxation of restrictions. Cities with high- to medium-risk districts now only account for roughly 8% of national GDP.
- Estimates suggest every additional month of severe lockdowns would trim annual growth by 0.5-0.6ppt.

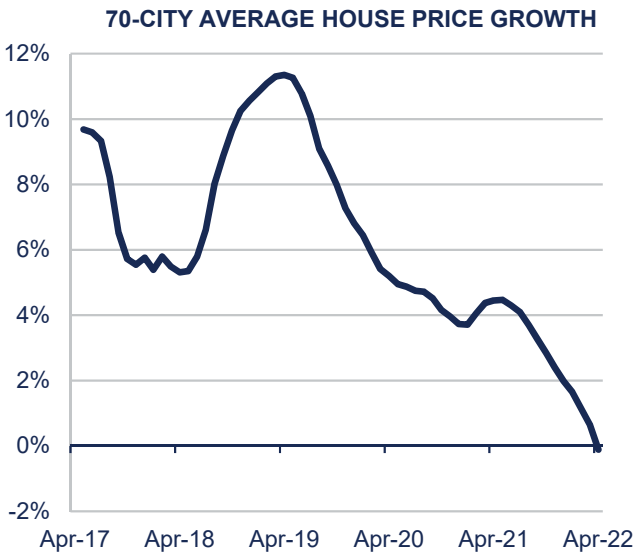
- Declining industrial profits has been a function of higher input prices, but also lockdown-related disruptions. This adds uncertainty to fixed asset investment, which remains among the few bright spots in the outlook.
- The SME sector has also been severely impacted despite its importance to the economy; it makes up 80% of non-government employment, 60% of GDP, and about 50% of national tax revenue.

- Measures implemented to support consumption have so far included a consumption tax cut and subsidies on appliance purchases.
- Authorities may shy away from cash disbursements as those will likely go direct to savings; loans are likely to be more effective as a form of stimulus.
- Effectiveness of stimulus measures will likely be dampened by ongoing or recurring lockdowns.

Source: Bloomberg and Haver. As of May 31, 2022.

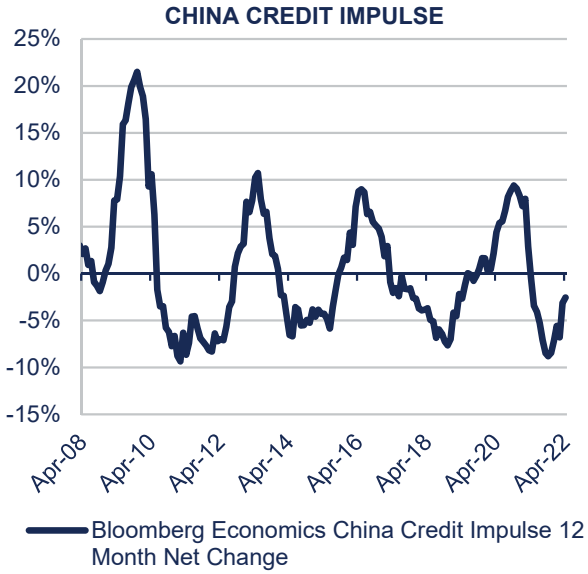
Asia Pacific

The PROPERTY recovery has yet to take hold.



- House prices saw negative growth for the first time in six-and-a-half years. Other activity measures, such as land purchases, new construction, and buildings sold, also remain in a downward trajectory.
- Our baseline assumes the government would prevent a complete collapse of the housing sector but is nevertheless taking a patient approach in providing support. Across all issues, this will be the hardest and longest to fix.

Any MONETARY AND FISCAL EASING has been smaller compared to 2020.



- The government has recognized the cost of its zero-COVID policy. But support measures have focused on supporting the survival of households, keeping the unemployment rate low, and assisting those with existing mortgages.
- Q2 and Q3 will likely be the worst quarters in terms of economic growth, but December could be the turnaround point, assuming the zero-COVID approach is loosened.

China's weakness may drag down GLOBAL DEMAND, particularly commodity exporters.

Country	Exposure to China as a % of Total Commodity Exports
Australia	48%
Brazil	44%
Chile	43%
Peru	34%
Indonesia	28%
Thailand	24%
U.S.	11%

- China accounts for about one-quarter of global trade of all commodities. Thus, a slowdown in domestic demand could have significant spillovers to global growth, particularly among commodity exporters.
- Countries most exposed appear to be metals and minerals and fossil fuel exporters, including Australia, Brazil, and Chile. The U.S. is also particularly exposed, with its exports primarily in agriculture and forestry products.

Source: Bloomberg, Haver and Goldman Sachs. As of May 31, 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. Both upside- and downside-risks are likely to determine the reaction of monetary and fiscal policy to provide much-needed support. Upside risks to inflation are also possible, given China's exposure to food.

Economic Growth	5/31/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
Japan Real GDP (Y/Y %)	0.2	-0.2	-4.6	1.8	1.9 ▼	1.8 --
China Real GDP (Y/Y %)	4.8	6.0	2.2	8.1	4.7 ▼	5.2 --
Inflation						
Japan CPI (Y/Y %)	2.5	0.5	0.0	-0.3	1.8 ▲	1.1 ▲
China CPI (Y/Y %)	2.1	2.9	2.5	0.9	2.2 --	2.3 --
Labor Market						
Japan Unemployment (%)	2.5	2.4	2.8	2.8	2.6 --	2.5 --
China Unemployment (%)	4.0	3.6	4.2	4.0	4.0 --	3.9 ▲
Rates						
Japan Central Bank	-0.10	-0.10	-0.10	-0.10	0.00 --	0.00 --
Japan 2Y Note	-0.08	-0.13	-0.13	-0.09	-0.02 ▲	-0.03 --
Japan 10Y Bond	0.23	-0.02	0.02	0.07	0.25 ▲	0.26 --
China Central Bank	4.35	4.35	4.35	4.35	4.30 --	4.30 --
China 2Y Note	2.21	2.63	2.71	2.36	2.46 ▼	2.34 ▼
China 10Y Bond	2.79	3.13	3.14	2.77	2.84 ▲	2.99 ▲
Currencies						
USD/JPY	128.72	108.61	103.25	115.08	127.00 ▲	120.00 ▲
USD/CNY	6.66	6.98	6.52	6.38	6.70 ▲	6.58 ▲

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of May 31, 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. Russian sanctions disrupt supplies of energy and other commodities. Central banks tighten aggressively to rein in inflation expectations. The adverse impact on growth is much stronger in Europe than in the U.S., given the former's energy dependence. With inflation above target and aggressive policy tightening, Europe risks a recession while the U.S. faces a serious slowdown.

As the Ukraine war drags on, **a widening embargo of Russian energy exports** by European, U.S., and allied countries takes shape as harsh financial sanctions are implemented. Russia may cut export of a number of commodities, too.

This comes at a dear cost, with energy prices surging to unseen levels, and may plunge the overexposed EU economies into a recession with elevated inflation. The U.S. is not as exposed thanks to its energy quasi-independence and less trade with Russia. However, its economy also slows down, as the energy shock and inflation hit 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. However, in the U.S., where inflation was already broad-based before the war, policy rates are raised gradually and full quantitative tightening is delayed. Compared to war, higher inflation becomes a lesser evil and is tolerated.

Slowing global growth, surging inflation, and rising policy rates prove difficult for emerging markets to digest. Big commodity exporters see the blows to their economies softened by improving trade terms, current account balances, and appreciating currencies. For other EMs, the going gets tough and financial instability could rise in the most vulnerable regions. 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 2.5% over 12-18 months.

Conditions

- Full embargo on Russian energy exports or similarly harsh 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

The above represent the views of Barings as of June 1, 2022, and are subject to change at any time. These predictions may not come to fruition.

Alternative Scenario: Higher for Longer

HIGHER FOR LONGER (20% ODDS)

Economic growth remains above-trend in advanced economies, but the energy shock keeps inflation from slowing down. 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 that has prevailed in Europe since the fall of the Berlin Wall and **presents European politicians with a stark choice: recession or appeasement of Putin's regime.** Energy prices and headline inflation stabilize but cannot slow 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. Strong summer tourism in Europe continues to boost demand through the fall and winter. China eases lockdown measures and activity returns to normal.**

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, a much more severe recession looms as central banks are forced to tighten policy sharply and even fiscal authorities focus on smaller deficits.

U.S. Treasuries: 10Y goes to 6% over 12-18 months, with curve steepening

Conditions
- Mixed results from energy embargo on Russia
- Ukraine conflict subsides
- 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

Alternative Scenario: Steeper Slide

STEEPER SLIDE (30% ODDS)

High inflation cuts into purchasing power and savings buffers for middle-income households. Uncertainty about central banks' ability to fight a price shock driven by commodity scarcity aggravates concerns about tightening financial conditions, and hikes prove too much given underlying weakness in demand. Goods inventories that companies accumulated for the post-pandemic boom prove excessive as demand weakens. China's battle against the virus contributes to a sharp global slowdown. A classic recession ensues as disinflation dynamics take hold.

The rise in commodities prices from the war in Ukraine and sanctions on Russia is a supply shock that central banks are not well-equipped to fight. Raising credit costs reduces consumers' ability to borrow in an effort to smooth the impact of lost purchasing power. **In the absence of commensurate wage growth, demand naturally self-adjusts downward**.

Firms find themselves with excess supply relative to restrained demand. Sanctions on Russia escalate to a full embargo on oil and gas imports in Europe (and, possibly, indirect sanctions on countries still trading with Russia) keep prices high. **Firms adjust supply down as higher energy costs lead to a decrease in demand.** Unemployment rises.

Central banks increase rates to tame inflation, but this proves too much and they are forced to reverse course. Some may not have had time to go very far from the lower bound of monetary policy. In addition, the fiscal room for maneuvering is limited by an already-high debt burden, making it difficult to fight the downturn. When it becomes obvious that policy easing is necessary, toward the second half of 2023, a recession toolbox is designed. Yields may be controlled and quantitative easing reactivated.

U.S. Treasuries: 10Y falls to 2% in 18 months with curve flattening or inverting

Conditions
- Harsh sanctions constrain global commodities supplies
- Wages grow below inflation average
- Zero-COVID policy the main pandemic-control tool in China

Indicators to watch
- Negotiations in Ukraine and the future of sanctions
- Wage negotiations

Scenario risks
- Resilient consumer demand

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As of March 31, 2022.

Important Information

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