BARINGS INVESTMENT INSTITUTE

July 2022

Whiplash!

MACRO DASHBOARD

BARINGS

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July Outlook – Whiplash!

Investor sentiment in recent weeks has pivoted sharply between worries about growth and fears of inflation. Good news on employment is bad news for price stability. Bad news on growth is good news for the rate outlook. With central banks' inflation models performing poorly and central banks offering limited forward guidance, markets are flying blind. **Investors have suffered whiplash**.

Inflation continues to run hot and the path ahead remains highly uncertain, but the resolve of central banks to control rising prices is increasingly evident. While they had been reluctant to hike too fast after a decade of weak growth and stable prices, central bankers seem increasingly worried they might be losing an inflation battle that could now be generational.

As both economic and political costs mount, we expect central banks to get much more aggressive to catch up. We are increasing the odds of our **Stagflation Shock** scenario to 60%, and we now see the Fed Funds Rate topping out above 4%, before falling back to 3.5% over the next 12-18 months. We anticipate a significant slowdown in demand, with recession almost certain in Europe and increasingly possible in the U.S. The U.S. 10-Year is also likely to settle at 2.5% over our horizon, and, at least over the next few months, risk assets should remain challenged. We expect select commodities, the dollar, and companies with strong balance sheets may be the best investor havens in such an environment.

With sentiment deteriorating globally, there is a risk that demand proves much weaker than we had imagined, triggering a deeper recession. If household purchasing power is destroyed amid surging prices and savings are quickly drawn down, we see a 30% chance of a **Steeper Slide,** in which the U.S. economy enters into a recession even without aggressive tightening. Given rising determination of central banks and a much dimmer outlook for European growth, we decrease the odds of our **Higher For Longer** scenario, in which growth remains above-trend despite high inflation, to 10%.

While inflation has been a global phenomenon, the **challenges in the U.S.** look more complicated given exceptional domestic demand. Amid fears of underlying weakness, an important test will be whether rising unemployment, slowing consumer spending, and deteriorating growth will see the Fed flinch. We think this is unlikely, but with the divergence between economic data and market expectations, volatility seems likely here to stay.

The situation appears much more dire in Europe, where there is looming risk that Russian gas supplies are curtailed, leading to an even larger commodity shock. This could severely undermine growth and, in the extreme, lead to something more akin to a **wartime economy**, including supply rationing and price controls—complicating the ECB's response and forcing it to pull back its current plans for modest rate hikes. While this raises fragmentation risks, a recession need not necessarily turn into a financial crisis.

As these adverse shocks intensify in the U.S. and Europe, recovery in China and Japan are now in question as global growth slows. Inflation has also finally arrived at their doorsteps, but absent a sustained domestic rebound, it is likely to remain manageable. While pandemic risks seem to have receded in most of the world, China's zero-COVID policy continues to cast a wide shadow, further increasing downside risks.

- Christian Floro

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 settles at 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 (10%)

- **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 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 (60%)

- **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 tops out above 4% before falling back to 3.5%
- **10-Year U.S. Treasuries**: Settle at **2.5%** in 12-18 months
- **Market Implications**: Protracted period of volatility. Supportive of select commodities, the U.S. dollar, and companies with strong balance sheets.

Scenario Matrix—Economy

		Scenarios						
		Steeper Slide		*Higher for Longer*		*Stagflation Shock*		
	Annual Averages	**2022**	**2023**	**2022**	**2023**	**2022**	**2023**	**Baseline scenario**
U.S.	Growth	1.5%*	0%	3%*	3%	2%*	1%*	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%	9%*	6%	8%*	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%	5%	
	Unemployment	7%	10%	6%	8%	7%	10%	
Japan	Growth	1.5%	0%	2.5%	2%	1%*	1%	A combination of **elevated commodity prices and weaker FX** is likely to lead to stickier inflation. Existing supply chain disruptions and trade exposure to the U.S. and China are significant downside risks.*
	Inflation	2%	1%	2%	2.5%*	2%	2%*	
	Unemployment	3%	4%	2.5%	2.5%	3%	3.5%	
China	Growth	2%	4%	4.5%*	4.5%*	3.5%*	4.5%	**Loose fiscal policy with stable monetary policy** will help cushion downside risks, but more support is likely needed. The zero-COVID policy is also unlikely to be lifted before fall, and growth should 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 July 15, 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: 5% Higher, stickier inflation takes hold as demand proves resilient. The Fed does not tighten enough through next year*	Fed Funds Rate: Tops out above 4% before falling back to 3.5% The energy shock causes a surge in inflation, and the Fed's current tightening brings inflation under control*
ECB	The ECB brings 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; YCC is unwound as inflation responds to the FX channel*	Policy rate stays negative; YCC bands widen or the target maturity shifts lower towards the end of the forecast horizon*
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	Neutral stance, focusing on window guidance to promote credit growth. Further policy rate cuts are unlikely*

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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% in 12-18 months*
Corporate Credit	Supportive duration, negative for high yield	Negative duration, positive credit amid robust economic growth	Neutral duration, negative credit*
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 quality 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	Selective support for commodities; positive energy on persistent supply-demand imbalance; precious metals see modest safe haven flows*

The above represent the views of Barings as of July 15, 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 June

WHAT'S NEW

- **Inflation continues to surprise on the upside** and is accelerating M/M
- **Inverted yield curve** signals recession risks
- **Gas rationing** is becoming increasingly likely in Europe
- The **U.K. government** has fallen and the key question is how much fiscal consolidation the new administration will implement
- **Japanese elections** and the landslide win to the Liberal Democratic Party (LDP) implies likely continuity, although questions remain about monetary policy next year when the next BOJ Governor is appointed
- Sporadic outbreaks renew **lockdown risks in China**

WHAT WE LEARNED

- Markets are **confused** about whether to fear inflation more than recession, but price pressures look likely to persist
- Inflation is rising even in those economies that were expected to be most insulated, like **Asia**
- Most **commodity markets** are starting to price in global recession
- **Rationing energy** in Europe would result in supportive policies

WHAT WE ARE HEARING FROM OUR TEAMS

- As earnings season kicks off, focus will be on **margins** and a revision down in earnings prospects
- Corporate credit teams are **cautious** amid the uncertain outlook, though eyeing increasingly attractive valuations
- Equities teams are focused on **strong balance sheets**
- Very difficult market environment for EM because every sovereign in the universe is challenged. This **unique crisis** means history will be less of a helpful guide

WHAT WE ARE WATCHING

- **Russian gas** flows to Europe
- **Unrest in EMs** and policy response
- Signs of decelerating **U.S. wage growth**
- **Consumer response** to higher inflation, tighter monetary policy, and greater uncertainty, including through savings
- **Quantitative tightening** and whether it leads to a significant liquidity crunch
- **Diverging signals from commodities,** with fundamentals supporting higher prices while markets suggest otherwise

Euro Area Demand Destruction Tracker

	Unemployment rate, %	Participation rate, %	Wages, YoY%	Consumer Confidence, Net positive responses	Retail Sales 3m/3m%	Stocks of Finished Goods, % Positive responses	Consumer Credit, 3m/3m%	Credit to Corporations, 3m/3m%
Jul-19	7.50	73.70	1.95	-6.30	0.37	4.20	2.35	1.16
Aug-19	7.40	73.70	1.93	-7.20	1.12	5.40	1.58	0.50
Sep-19	7.50	73.70	1.95	-6.90	0.28	5.70	1.01	0.18
Oct-19	7.50	73.80	1.88	-7.50	-0.28	5.00	0.66	-0.04
Nov-19	7.50	73.80	1.83	-6.80	0.46	6.00	0.88	0.16
Dec-19	7.50	73.80	1.88	-7.80	-0.09	4.40	1.40	-0.36
Jan-20	7.50	72.90	1.94	-7.50	1.20	4.90	0.97	-0.38
Feb-20	7.40	72.90	1.94	-6.30	0.82	4.80	0.67	-0.39
Mar-20	7.20	72.90	1.98	-12.00	-9.07	3.50	-1.15	3.08
Apr-20	7.40	71.10	1.82	-24.50	-20.04	4.40	-3.12	4.33
May-20	7.60	71.10	1.89	-20.20	-4.72	8.40	-3.45	5.48
Jun-20	8.10	71.10	1.86	-14.20	11.29	8.70	-1.36	2.75
Jul-20	8.40	73.10	1.82	-14.50	25.06	6.40	1.18	1.54
Aug-20	8.60	73.10	1.80	-14.20	8.19	6.50	1.00	0.35
Sep-20	8.60	73.10	1.77	-13.00	1.54	5.80	-0.10	-0.10
Oct-20	8.40	73.00	1.75	-14.80	3.28	5.20	-0.35	-0.28
Nov-20	8.20	73.00	1.74	-16.80	-5.46	6.50	-0.18	-0.07
Dec-20	8.20	73.00	1.72	-12.20	-1.25	8.00	-0.15	-0.54
Jan-21	8.30	72.50	1.47	-14.00	-7.50	6.40	-1.56	-0.68
Feb-21	8.20	72.50	1.43	-13.20	1.49	7.70	-1.49	-0.66
Mar-21	8.20	72.50	1.39	-9.50	2.08	4.70	-1.10	1.37
Apr-21	8.20	73.50	1.47	-9.70	3.91	4.40	-0.60	0.85
May-21	8.10	73.50	1.40	-5.30	4.68	4.50	-0.05	0.68
Jun-21	7.90	73.50	1.40	-1.80	3.01	5.20	0.32	-0.48
Jul-21	7.60	74.50	1.33	-3.70	4.68	2.40	1.33	0.38
Aug-21	7.50	74.50	1.34	-5.20	0.61	3.50	0.90	0.05
Sep-21	7.30	74.50	1.38	-3.80	-1.37	2.70	0.21	0.43
Oct-21	7.30	74.40	1.4	-5.3	0.8	1.60	0.0	0.5
Nov-21	7.10	74.40	1.4	-8.2	1.5	1.90	0.8	1.6
Dec-21	7.00	74.40	1.5	-9.3	-0.8	0.10	0.2	2.0
Jan-22	6.90	74.20	1.7	-9.7	-0.8	1.80	-0.6	1.8
Feb-22	6.80	74.20	1.7	-9.5	-1.5	-0.20	-1.2	1.3
Mar-22	6.80	74.20	1.9	-21.6	1.2	-1.20	-0.2	1.4
Apr-22	6.70		2.0	-22.1	-0.4	0.10	0.7	1.8
May-22	6.60		2.1	-21.2	-0.7	-0.70	1.3	2.1
Jun-22			2.7	-23.6		-0.40		

Source: Haver. As of July 14, 2022.

U.S. Demand Destruction Tracker

	Manufacturing New Orders Index	Retail Sales, 3m/3m%	Consumer Credit Cards/Rev Plans, 3m/3m%	Initial Claims for Unemployment Insurance	Michigan Consumer Expectations	New Housing Units Authorized, 3m/3m%	Average Hours: Manufacturing Industry, 3m/3m%	Unemployment Rate, %	Nominal Wages, YoY%
Jan-19	57.00	-0.92	0.73	217	79.90	-1.18	-0.94	4.00	3.25
Feb-19	55.90	-0.84	0.55	205	84.40	-1.06	-1.41	3.80	3.55
Mar-19	56.60	2.25	1.05	186	88.80	0.77	-0.47	3.80	3.54
Apr-19	53.50	1.81	1.07	194	87.40	6.15	0.48	3.60	3.31
May-19	52.50	1.96	1.06	218	93.50	2.90	1.19	3.60	3.26
Jun-19	50.70	0.81	1.10	238	89.30	-1.06	0.24	3.60	3.37
Jul-19	50.50	1.63	1.04	225	90.50	2.48	-0.71	3.70	3.43
Aug-19	46.40	1.61	1.19	228	79.90	10.08	-0.47	3.70	3.38
Sep-19	47.50	0.79	0.94	219	83.40	12.13	0.24	3.50	3.08
Oct-19	48.10	0.16	0.85	225	84.20	11.52	0.71	3.60	3.18
Nov-19	47.80	0.12	0.34	231	87.30	0.81	0.00	3.60	3.35
Dec-19	47.60	1.57	0.44	236	88.90	-1.51	-1.18	3.60	2.94
Jan-20	52.90	0.87	0.88	203	90.50	-1.78	-0.71	3.50	3.01
Feb-20	50.80	0.84	1.15	191	92.10	-2.67	-0.71	3.50	3.10
Mar-20	42.30	-8.70	0.91	2664	79.70	-3.89	-0.95	4.40	3.56
Apr-20	27.00	-22.33	-5.80	4190	70.10	-27.39	-3.57	14.70	8.03
May-20	32.30	-8.19	-9.51	2055	65.90	-13.80	-1.91	13.20	6.68
Jun-20	56.80	9.36	-10.48	1483	72.30	-3.25	-0.24	11.00	5.08
Jul-20	60.30	31.71	-4.92	1307	65.90	43.27	2.96	10.20	4.92
Aug-20	65.40	11.80	-2.08	892	68.50	21.02	1.46	8.40	4.80
Sep-20	59.80	5.10	-1.23	841	75.60	20.63	-4.83	7.90	4.83
Oct-20	67.30	2.60	-1.08	797	79.20	2.96	-0.24	6.90	4.61
Nov-20	65.10	0.70	-0.53	757	70.50	10.66	0.24	6.70	4.59
Dec-20	67.40	-1.62	-0.51	829	74.60	7.19	6.35	6.70	5.46
Jan-21	63.50	4.14	-0.85	833	74.00	15.26	0.48	6.40	5.28
Feb-21	66.40	3.47	-0.82	755	70.70	3.63	-0.24	6.20	5.18
Mar-21	66.90	15.25	-0.81	666	79.70	2.49	0.72	6.00	4.41
Apr-21	64.30	9.24	-1.11	565	82.70	-4.23	0.72	6.00	0.63
May-21	66.30	10.70	0.07	455	78.80	-2.98	0.96	5.80	2.19
Jun-21	66.40	0.32	1.46	417	83.50	-6.32	-0.71	5.90	3.95
Jul-21	65.00	-0.82	3.40	409	79.00	-6.23	-1.43	5.40	4.28
Aug-21	65.50	0.29	3.26	396	65.10	4.79	-0.95	5.20	4.34
Sep-21	64.40	0.50	2.59	365	68.10	-2.77	-0.48	4.70	4.78
Oct-21	60.60	3.26	2.76	302	67.90	2.60	0.96	4.60	5.35
Nov-21	61.40	3.20	3.20	254	63.50	-2.43	0.00	4.20	5.33
Dec-21	61.00	0.55	3.74	222	68.30	17.40	0.96	3.90	4.88
Jan-22	57.90	1.66	3.37	227	64.10	8.42	-0.95	4.00	5.45
Feb-22	61.70	2.73	3.12	195	59.40	7.40	0.96	3.80	5.19
Mar-22	53.80	5.61	4.03	175	54.30	-0.90	0.48	3.60	5.62
Apr-22	53.50	3.55	5.03	188	62.50	-0.98	-1.20	3.60	5.50
May-22	55.10	1.74	5.01	209	55.20	-8.72	-0.71	3.60	5.34
Jun-22	49.20	1.59	4.69	232	47.50	-10.32	-1.42	3.60	5.11

Source: Bloomberg and Haver. As of July 15, 2022.

Monthly Spotlight: How bad could Russian gas cuts be for Europe?

The odds of a potential cut in Russian gas to Europe are hard to predict, but the consequences of a worst-case scenario look dire. Already, the Nord Stream 1 pipeline, which supplies about 25% of Russian gas to Europe, was functioning at 40% of its capacity since May, resulting in a 60% rise in gas prices. It is now down for a 10-day maintenance period. The risk is high that Russia keeps gas supply curtailed to strengthen its hand in future negotiations on the division of Ukraine. Given limited alternatives to Russian gas and the rise in demand in the winter, rationing will worsen a situation of weakening growth and accelerating inflation.

Governments are preparing to reallocate resources across the most important sectors of the economy. Gas reserves stand at an average 3 months of needs, some 60% of total storage capacity, short of what is sufficient to comfortably run down supplies now without raising their imports dependence later in the year.

Europe is dependent on Russia gas for 40% of its needs and the economic impact of a full cut-off of imports would be enormous. Governments have been trying to diversify energy sources, in particular from the United States and Qatar in the past few months, but it is far from enough and does not change the outlook materially for this year and next. Rationing, higher commodities prices, and intensified global value chain problems would result in production cuts.

EURO AREA: SEVERE IMPACT OF GAS RATIONING ON GROWTH

	2020	2021	2022	2023	2024
Euro area	-6.5	5.3	1.3	-4.1	-1.3
Germany	-4.9	2.9	-1.3	-7.5	-5.4
France	-7.9	6.8	1.5	-1.3	1.3
Italy	-9.1	6.6	1.9	-3.3	0.5
Spain	-10.8	5.1	4.0	-1.8	1.0

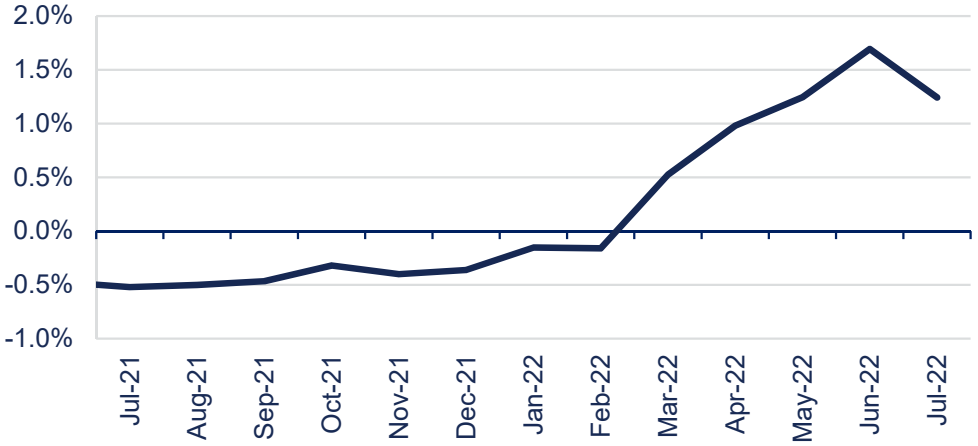
If governments decide to impose price controls to shield households, fiscal deficit would soar, especially if firms need support to avoid passing on higher costs to consumers

We rely on estimates of the impact of such shock as prepared by European governments (Table). They assume a complete stop to gas imports from the third quarter of this year. In Germany, the country with the largest dependence on Russian gas, the Bundesbank has used a sophisticated input-output matrix of the economy to estimate that growth may fall 7.5% in 2023. The entire Euro Area economy could contract 4.1%.

These numbers are not priced in by market participants. Neither the probability of this shock, nor its precise impact on growth and inflation can in fact be easily quantified. The outcome is binary—either Russia cuts gas supply or it does not. The numbers we discuss here show an impact much worse than expected (see consensus numbers in the deck).

In such environment, we believe the ECB would not hike in 2023. Expectations of ECB rate hikes stand at 180bps in the next 12 months and include one 25bps hike in 2023 that would thus not happen (Chart).

EXPECTED ECB HIKES IN 12 MONTHS



Source: Bloomberg, national authorities, Barings calculations. As of July 14, 2022.

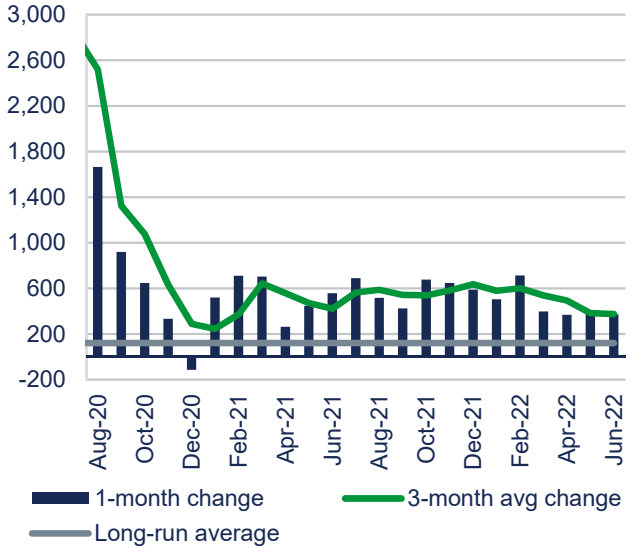
United States

LABOR MARKET strength with upward surprises in the pace of job gains...

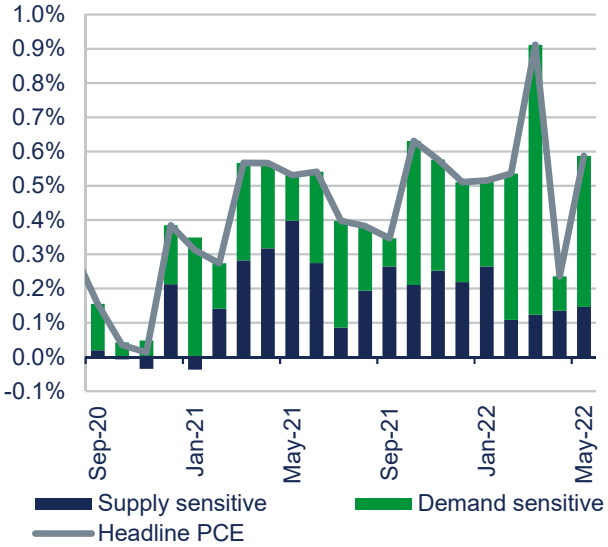
...combined with still-elevated and broad-based INFLATION...

...will likely lead the Fed to HIKE RATES more than is currently priced in.

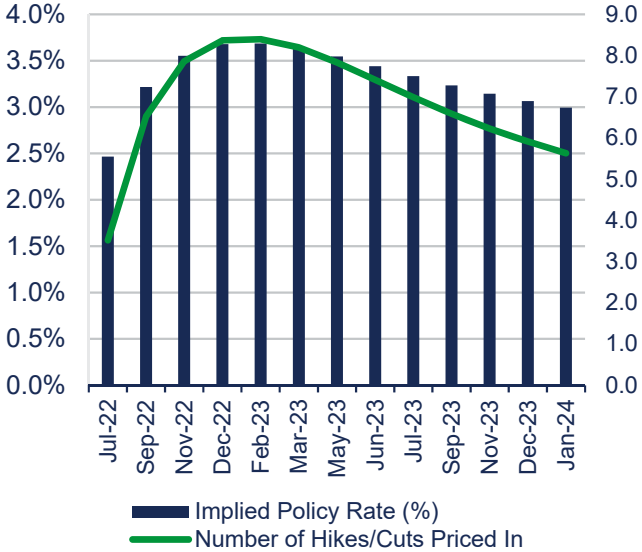
CHANGE IN NONFARM PAYROLLS



PCE DEFLATOR, M/M%



IMPLIED OVERNIGHT RATE AND HIKES



- The labor market remains very strong, with an upward surprise in job growth in June. Meanwhile, the number of job openings per unemployed—a measure of labor market tightness—remains near a record-high.
- The upward surprise in job growth combined with still too-elevated nominal wage growth will add support to the Fed's stance for an aggressive path of rate hikes.
- However, looking ahead, as monetary policy tightens and the economy slows, we expect job growth to ease and the unemployment rate to tick higher.

- Headline inflation is now rising at the fastest pace since 1981. While the supply shock facing much of the world is boosting price pressures, U.S. inflation is also being driven by demand.
- Analysis by Deutsche Bank shows that inflation is being increasingly driven by demand vs. supply factors. As of May, 2/3 of PCE inflation was due to demand factors.
- This means there is still room for the Fed to bring down price pressures by raising rates. This stands in contrast to other regions, such as the euro area.

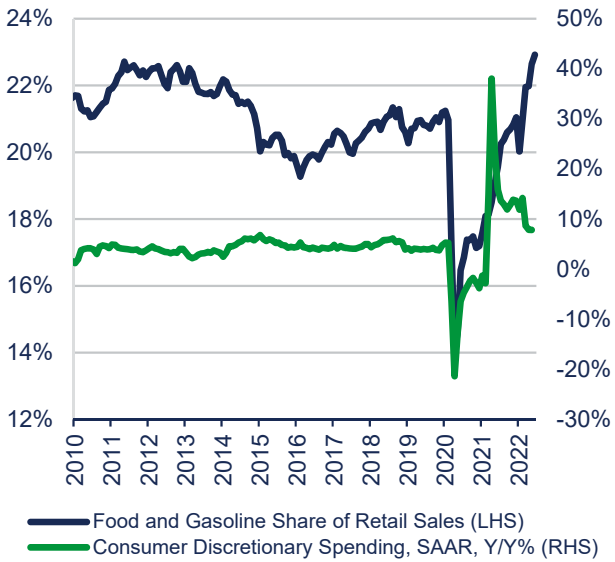
- The upward surprise in employment and high inflation data supports the Fed's outlook for a more aggressive front-loading of rate hikes.
- The Fed is now looking for a downward trend in M/M growth in inflation before it will reverse course. This will take multiple monthly reports.
- Given that the FOMC is clearly weighing inflation over growth, even if Q2 GDP comes in weak, we do not think this will alter the Fed's course.

Source: Haver, Deutsche Bank, and Bloomberg. As of July 14, 2022.

United States

As prices for necessities rise, DISCRETIONARY CONSUMPTION is set to slow.

CONSUMER SPENDING



- As prices for necessities rise, consumers are having to devote a larger share of their incomes on these items. The share of retail sales spent on food and gasoline has increased to above pre-pandemic levels, standing at 23% in June.
- With more money being diverted to necessities and real wage growth in negative territory, we expect to see a slowing in discretionary spending, particularly in 2023.

Despite strong economic data, RECESSION RISKS are rising given inflation and tightening monetary policy.

10-2 YEAR U.S. TREASURY YIELD SPREAD

- While the hard economic data has remained impressively resilient, given pent-up demand, recession risks are top-of-mind, with the yield curve inverting.
- The divergence between hard economic data, expectations of a slowdown, and little forward guidance from the FOMC are likely to keep uncertainty high as investors attempt to gauge what each print means for the Fed.
- Moreover, if fears of a complete shutoff of Russian gas to Europe come to fruition, this would add further pressure to recession worries.

FOMC rate hike expectations and rising global recession fears have driven U.S. DOLLAR STRENGTH.

U.S. DOLLAR INDEX SPOT

- Both the aggressive path of rate hikes from the Fed and rising fears of recession across the globe have driven U.S. dollar strength.
- Rising concerns of further energy disruptions from Russia to the euro area are boosting concerns of a more severe euro area recession, which is supporting the safe haven bid.
- Separately, the easing policy stance by the Bank of Japan stands in stark contrast to the Fed, and the resulting depreciating yen is adding further upside to the dollar.

Source: Bloomberg, Haver, and Barings calculations. As of July 15, 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	7/18/2022	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	2.1 ▼	1.3 ▼
Inflation						
CPI (Y/Y %)	9.1	1.8	1.2	4.7	7.9 ▲	3.6 ▲
Core PCE (Y/Y %)	4.7	1.7	1.4	3.3	4.7 --	3.0 ▲
Labor Market						
Unemployment (%)	3.6	3.7	8.1	5.4	3.7 ▲	3.9 ▲
Rates						
Fed Funds	1.63	1.63	0.13	0.13	3.55 ▲	3.25 ▼
2Y Treasury	3.17	1.57	0.12	0.73	3.41 ▲	3.01 ▼
10Y Treasury	2.98	1.92	0.92	1.51	3.31 ▲	3.10 ▼

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of July 18, 2022. (E)—Bloomberg private market consensus estimates.

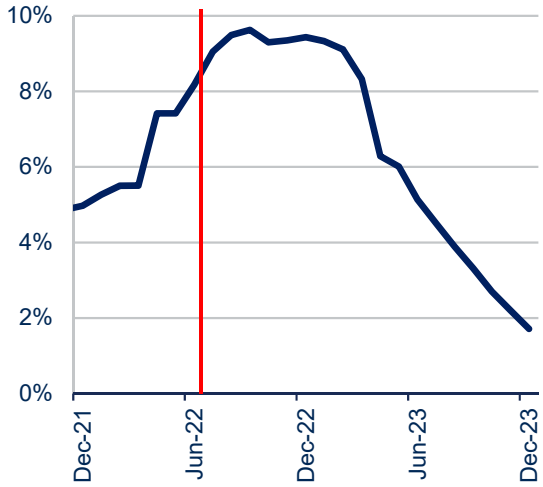
Europe

INFLATION is not coming down anytime soon in Europe.

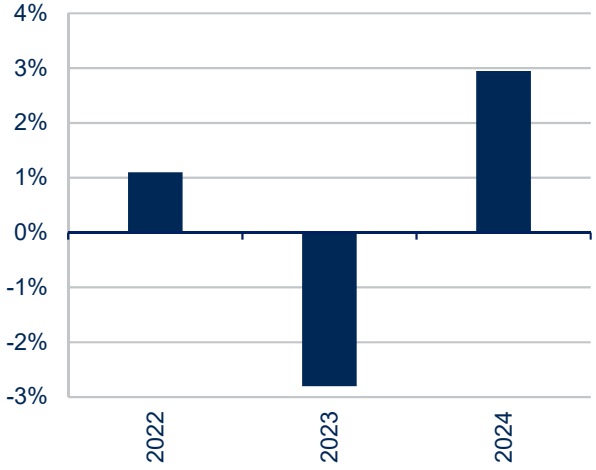
ENERGY RATIONING would impact growth well beyond current expectations.

WAGES are not keeping up with inflation, hurting consumers.

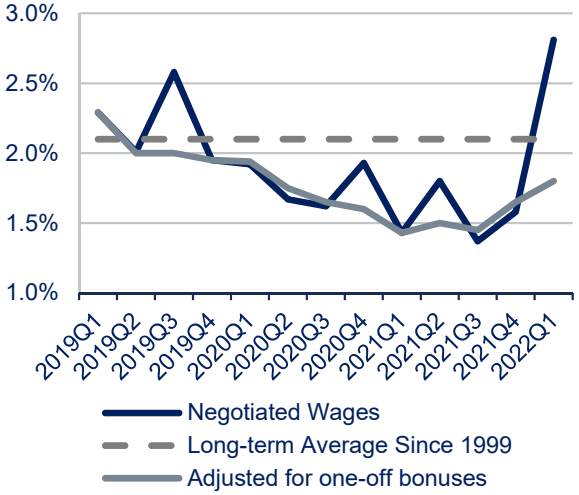
PROJECTED EURO AREA INFLATION, Y/Y%



REAL GDP GROWTH, SEVERE SCENARIO



NEGOTIATED WAGES
ANNUAL % CHANGE



- Even barring further cuts in Russian gas supplies, we estimate euro area inflation will remain extremely elevated until the next summer.
- Under these assumptions, inflation would hit the 2% ECB target by end of 2023, still giving an average 5.2% inflation for the year, almost 2pps above current market and ECB expectations.
- A full Russian energy ban would have serious consequences, as discussed in the Monthly Spotlight on Slide 11.

- Euro area countries have on average three months' gas use stored, and Russia's supply's reduction makes stocking up before winter unlikely.
- Reducing spending on essential goods like energy is difficult, so gas supplies will likely be rationed.
- Households will likely be spared rationing, so most of the impact will be on industries. Expect 2023 growth to be revised down, well beyond the current ECB scenarios (see above).

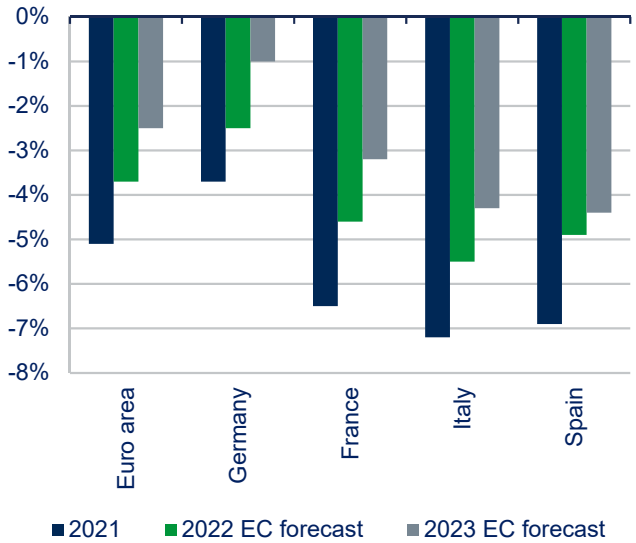
- Wages are accelerating but not comparably with prices, and households' purchasing power is suffering as a result.
- Adjusting for one-off bonuses which are not stable wages increases, these have grown less than 2% in the last year, compared with inflation at 5.5%.
- With no signs of inflation slowing down, purchasing power and consumer confidence are likely to suffer and consumption should slow markedly in the coming months.

Source: Bloomberg and Haver. As of July 13, 2022.

Europe

FISCAL POLICY will need to pick up the baton.

FISCAL DEFICITS (% GDP)



- Deficit targets will likely have to be eased as monetary policy cannot accommodate the shock with inflation so elevated.
- Germany will likely let go of its constitutional debt brake, and other countries will have to follow suit.
- Spending to gather some energy security through renewables is likely to be prioritized, even if interest costs for euro area governments are already rising.

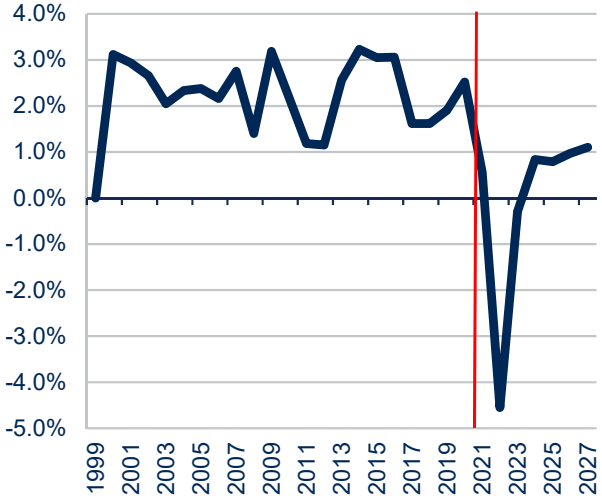
FRAGMENTATION RISKS have increased…

SPREADS STANDARD DEVIATION

- Inflation-fueled tightening by the ECB heightens fragmentation risks as higher rates increase interest burdens of highly indebted countries.
- The ECB aims for financial conditions to be tightened evenly across member states and will endeavour to reduce the deviation of spreads from the euro area average rate, allowing rates to rise in the process.
- An anti-fragmentation tool with this objective was expected to be unveiled in mid-July; we estimate the ECB fragmentation measure as pictured above.

…but should not be overblown as INFLATION HELPS ITALY.

REAL INTEREST RATE COSTS, ITALY



- While rising rates are costly for indebted countries, risks of a euro area breakup should not be overblown.
- Inflation is actually a boon for highly indebted countries like Italy, as it increases government revenues more and faster than it increases interest costs, thereby increasing debt sustainability.
- Thanks to the current bout of inflation, Italy's interest costs net of inflation will dip to -4%, the lowest recorded in at least 40 years.

Source: Bloomberg and Haver. As of July 17, 2022.

Europe

CONSENSUS FORECAST

- A reduction of Russian gas supplies to Europe has hindered countries' ability to restock storage facilities before the winter, and the mother of all commodity shocks is looming large. Should Russia decide to fully cut gas supplies, gas rationing would become unavoidable, with serious consequences for manufacturing and growth. Even a smaller restriction of supplies would create a powerful stagflationary shock, plunging Europe into a recession. This is our central scenario.

Economic Growth	7/18/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
EZ Real GDP (Y/Y %)	5.4	1.6	-6.3	5.4	2.7 ▲	1.4 ▼
U.K. Real GDP (Y/Y %)	8.7	1.7	-9.3	7.5	3.4 ▼	0.8 ▼
Inflation						
EZ CPI (Y/Y %)	8.6	1.2	0.3	2.6	7.5 ▲	3.4 ▲
U.K. CPI (Y/Y %)	9.1	1.8	0.9	2.6	8.5 ▲	5.0 ▲
Labor Market						
EZ Unemployment (%)	6.6	7.6	8.0	7.7	6.9 ▼	7.0 ▲
U.K. Unemployment (%)	3.8	3.8	4.5	4.6	3.9 --	4.3 ▲
Rates						
EZ Central Bank	0.00	0.00	0.00	0.00	1.20 ▲	1.55 ▼
EZ 2Y Note	0.51	-0.61	-0.72	-0.64	1.20 ▲	1.11 ▲
EZ 10Y Bond	1.22	-0.19	-0.57	-0.18	1.61 ▲	1.47 ▲
U.K. Central Bank	1.25	0.75	0.10	0.25	2.05 ▲	2.00 ▲
U.K. 2Y Gilts	1.95	0.53	-0.17	0.66	2.17 ▲	1.52 ▼
U.K. 10Y Gilts	2.14	0.82	0.19	0.97	2.38 ▲	1.89 ▼
Currencies						
EUR/USD	1.02	1.12	1.22	1.14	1.06 ▼	1.11 ▼
GBP/USD	1.20	1.33	1.37	1.35	1.22 ▼	1.28 ▼

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of July 18, 2022. (E)—Bloomberg private market consensus estimates.

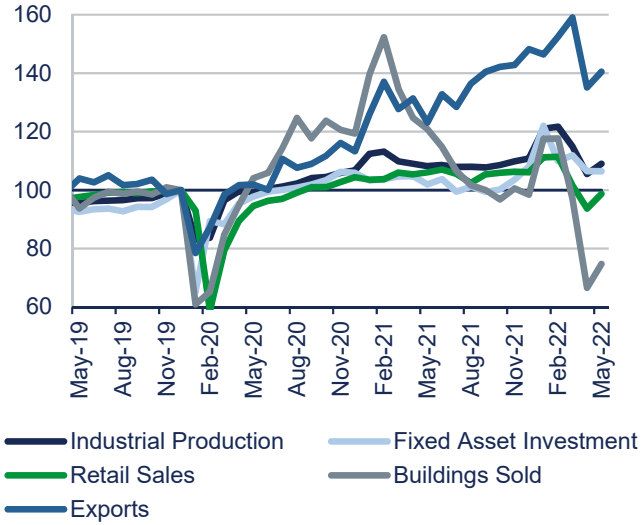
Asia Pacific

With global growth set to slow, the China RECOVERY will likely be fleeting…

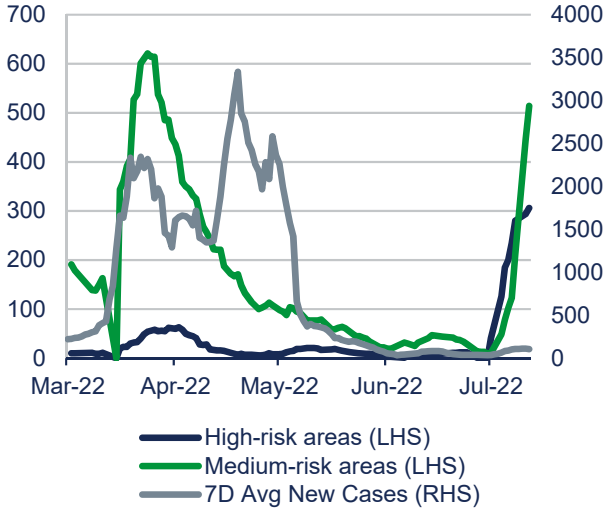
…as it faces two dueling negative shocks: COVID, which is weighing on sentiment…

…and RISING INFLATION amid elevated commodity prices stemming from the war in Ukraine.

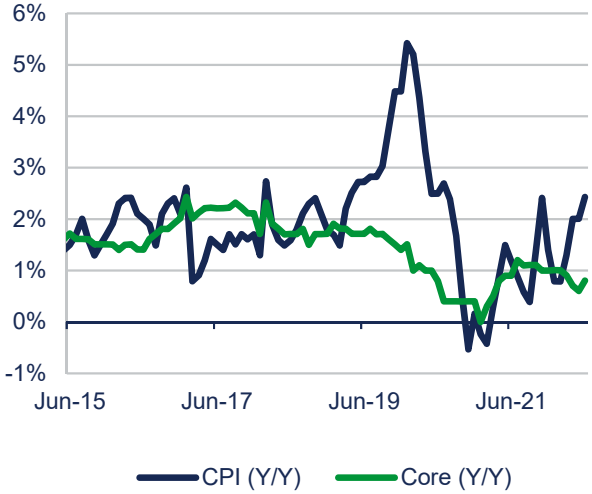
CHINA ECONOMIC INDICATORS INDEXED TO DEC 2019



CHINA NUMBER OF AREAS AT RISK VERSUS NEW CASES



CHINA INFLATION



- External sectors—exports and industrial production—have benefited from the ongoing global reopening, while retail sales and services have lagged.
- The revival of domestic demand, particularly on consumption, could help offset the fading external tailwind.
- This will depend on whether there is a meaningful move away from the zero-COVID policy this year and whether fiscal policy, which remains uncertain, delivers.

- The number of cities with mid- to high-risk districts have increased to 26% of GDP, compared to the April peak of 35%.
- Authorities have taken baby steps to relax the zero-COVID policy, including loosening quarantine requirements, but concerns around future lockdowns are casting a wide shadow over the economy.
- Together with the negative wealth effect from the weak property sector, consumers and corporates may continue to act risk-averse.

- Food could be a larger upside risk to inflation, given its large 20% share in headline CPI.
- Energy makes up only 2-3%, and prices are set by the government. Subsidies, together with high domestic inventories, should also help absorb the upside risks.
- Offsetting these risks should be muted core inflation, given ongoing pressures on the labor market and consumption, and elevated inventories, particularly energy.

Source: Bloomberg, Haver and Goldman Sachs. As of July 13, 2022.

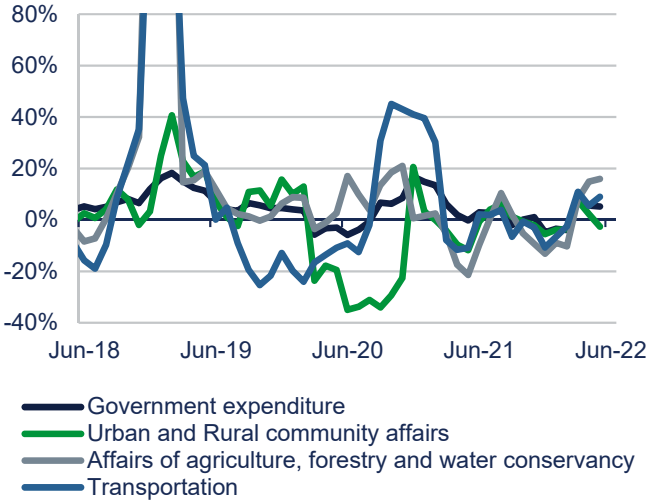
Asia Pacific

Stable monetary policy together with loose FISCAL POLICY has been the preferred response, but more will be needed.

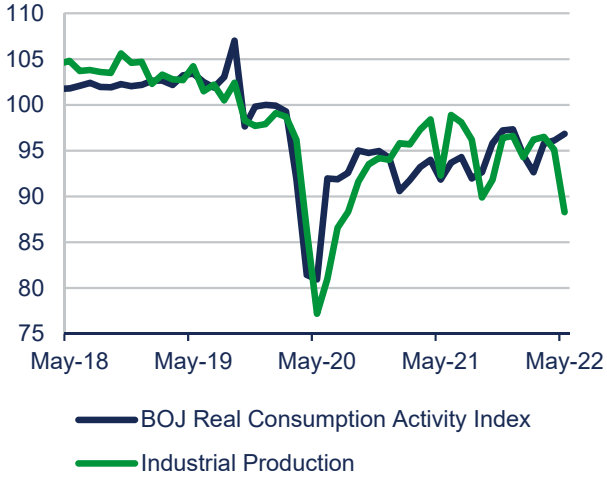
In Japan, the post-COVID rebound may be overshadowed by RECESSIONARY RISKS from inflation and stagnating global growth.

This will challenge the BOJ, which is unlikely to stray from yield curve control despite a WEAKENING YEN.

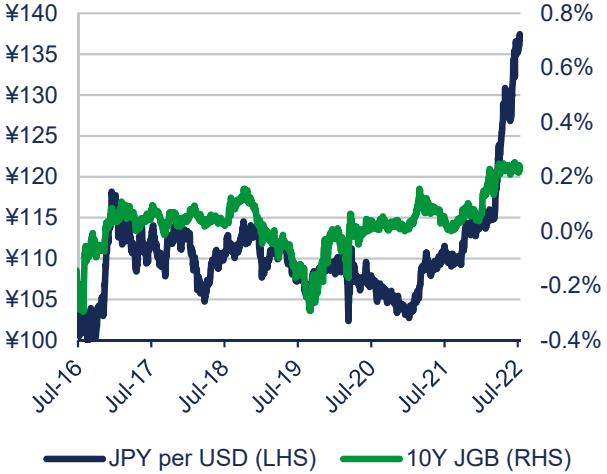
FISCAL EXPENDITURE GROWTH ON SELECT CATEGORIES



JAPAN HOUSEHOLD AND INDUSTRIAL ACTIVITY



JAPANESE YEN & 10Y GOVERNMENT BOND



- A rebound in infrastructure investment is likely as authorities plan to front-load credit growth early next year.
- The overall response will continue to be managed and risks are to the downside that stimulus under-delivers.
- Local governments will likely face continued constraints in outlays, given a smaller pipeline of projects and increased regulations on use of government debt proceeds amid the ongoing anti-corruption campaign.

- The recovery in consumption and tailwinds from the economic reopening—given elevated savings, pent-up demand, and travel subsidies announced in July—may be on shaky ground.
- Inflation is eating into household purchasing power while also squeezing corporate profits.
- Domestic growth may also suffer because of external demand shock from U.S. and China, Japan's top export destinations.

- Diverging monetary policy, together with increasing inflation, is adding pressure to the yen.
- Fiscal policy has been aimed to counter rising import prices, including providing subsidies to gasoline and direct household transfers.
- Monetary policy is focused on re-anchoring inflation expectations higher. Thus, a shift is unlikely until next year, when the next BOJ Governor is appointed.

Source: Bloomberg and Haver. As of July 13, 2022.

CONSENSUS FORECAST

- We expect below-consensus 2022 growth in Japan amid the commodity price shock hurting an 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. Both upside- and downside-risks will likely be determined by the reaction of fiscal policy to provide much-needed support. Upside-risks to inflation are also possible, given China's large exposure to food in CPI.

Economic Growth	7/18/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
Japan Real GDP (Y/Y %)	0.4	-0.2	-4.6	1.8	1.6 ▼	1.8 ▼
China Real GDP (Y/Y %)	0.4	6.0	2.2	8.1	4.1 ▼	5.2 --
Inflation						
Japan CPI (Y/Y %)	2.5	0.5	0.0	-0.3	2.0 ▲	1.2 ▲
China CPI (Y/Y %)	2.5	2.9	2.5	0.9	2.3 ▲	2.3 --
Labor Market						
Japan Unemployment (%)	2.6	2.4	2.8	2.8	2.6 --	2.5 --
China Unemployment (%)	4.0	3.6	4.2	4.0	4.1 ▲	3.9 --
Rates						
Japan Central Bank	-0.10	-0.10	-0.10	-0.10	0.00 --	0.00 --
Japan 2Y Note	-0.07	-0.13	-0.13	-0.09	-0.06 ▼	-0.04 ▼
Japan 10Y Bond	0.23	-0.02	0.02	0.07	0.26 ▲	0.27 ▲
China Central Bank	4.35	4.35	4.35	4.35	4.30 --	4.30 --
China 2Y Note	2.19	2.63	2.71	2.36	2.33 ▼	2.30 ▼
China 10Y Bond	2.78	3.13	3.14	2.77	2.85 ▲	2.98 --
Currencies						
USD/JPY	138.05	108.61	103.25	115.08	132.00 ▲	123.00 ▲
USD/CNY	6.74	6.98	6.52	6.38	6.72 ▲	6.55 ▼

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of July 18, 2022. (E)—Bloomberg private market consensus estimates.

Central Scenario: Stagflation Shock

STAGFLATION SHOCK (60% 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 Russia-Ukraine conflict
- Complete change of the policy toolbox

Alternative Scenario: Higher for Longer

HIGHER FOR LONGER (10% 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 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 are 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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