September 2022

Frontloading

MACRO DASHBOARD

BARINGS

22-2422772

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- A strong labor market, healthy household balance sheets, and broad-based inflation are set to lead the FOMC to hike more than is currently priced into markets. The delayed impact of monetary policy and high prices for necessities will weigh on demand and slow growth materially, particularly in the second half of 2023, with risks of a mild recession.

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- Uncertainty about the energy shock and the policy response translate into an uncertain growth-inflation path. Our baseline assumes energy rationing and little ability for policy to rapidly smooth the impact on the economy.

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- China's zero-COVID policy and ongoing reforms in the property sector are likely to lead to a lasting slowdown absent more aggressive policy support. Monetary policy, while still supportive, will likely take a back seat for now as government spending ramps up. In Japan, the rebound has been sluggish, and weakening global growth will only add to headwinds.

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September Outlook – Frontloading

In spite of resilient economic momentum in the first half of 2022, global **uncertainty related to the war in Ukraine, commodity shortages, and central banks' resolute fight against inflation darken the outlook**. Our central **Stagflation Shock** scenario, introduced in March, **spelled out most of these dynamics**. In the U.S., consumers equipped with strong balance sheets, excess savings, rising credit, and a strong labor market have a lower sensitivity to higher prices. Reopening of the economy and a strong summer tourism season in Europe were a boon to growth. While data has surprised to the upside, this is no reason to turn bullish on the outlook. In fact, **the stronger underlying momentum is leading most major central banks to aggressively frontload rate hikes to reel in inflation**. We continue to believe that this backdrop will lead the FOMC to hike more than is currently priced into markets. In the euro area, the pass-through of the energy price shock to core inflation has led the European Central Bank to **frontload** rate hikes to rein in price pressures and consumer inflation expectations. Energy storage levels are better than expected, but a colder-than-normal winter would likely require some rationing.

Given these persistent trends, we keep Stagflation Shock our central scenario with 60% odds. The euro area is likely facing a recession this year. While the U.S. is relatively more shielded given energy independence and stronger household balance sheets, higher prices for necessities, rising interest rates, and the likely resumption of student loan payments next year should slow the pace of consumer spending while higher mortgage payments are cooling demand in the housing market. This should set the U.S. up for a material slowdown in growth, particularly in the second half of 2023, with risks of a mild recession. Growth in China is set to disappoint given continued COVID lockdowns, a tepid rebound in internal demand, and property sector weakness weighing on sentiment and credit growth. In Japan, the growth rebound has been sluggish, and weakening global growth will only add to headwinds.

Yet there is still a possibility that growth continues to surprise to the upside, particularly in the U.S. **Strong jobs reports and resilient household consumption have led us to upgrade the probability of our alternative Higher for Longer scenario, from 10% to 20%.** Higher growth and supply-side shocks could keep inflation exceedingly elevated, requiring a more aggressive response from the Federal Reserve than is in our baseline. While monetary policy would tighten, it would not be enough to bring inflation down to target within 12-18 months. Such a scenario would prove particularly challenging for central banks and could lead to greater problems in 2024, as more aggressive tightening would likely be needed and risk a much deeper recession.

Given the high uncertainty on the outlook and lag in economic data, we have reduced the odds of our Steeper Slide scenario from 30% to 20% given the strength in activity so far and the proactive fiscal policy support. In this scenario, underlying economic momentum proves much weaker given poor sentiment and U.S. savings buffers that fail to spur consumption. Central banks tighten but aren't able to hike as much as is currently priced into markets. This proves too much for global economies, the U.S. and Europe fall into recession, and weak growth in China weighs further on global growth.

With most major central banks turning increasingly hawkish, good economic data doesn't mean good news for markets, as policymakers focus on the inflation portion of their mandates, and strong demand likely means more tightening. After a delayed start, central bankers are doing their best to make up for lost ground.

- Kathryn Asher

Barings Investment Institute Scenarios for the Next 12-18 Months

STEEPER SLIDE (20%)

- **Demand falls sharply with high inflation**. Lower purchasing power and the fallout in financial markets amid tight financial conditions reduce savings buffers. Weakening sentiment makes the large inventories that firms 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 next year as demand falters. The Fed begins to cut rates early next year**.
- **Policy Hikes:** Fed Funds Rate settles at **2.5%**
- **10-Year U.S. Treasuries**: **2%** with **curve inverting** in the process

HIGHER FOR LONGER (20%)

- **Energy shocks and supply chain disruptions** add to strong labor bargaining power and the costs of the green transition when commodity prices are already high.
- **Household savings strength and fiscal support** reduce demand sensitivity to prices. This gives firms pricing power to pass-through higher input costs. Banks have space to lend, helping the economy buffer rising inflation.
- **Monetary policy is only weakly effective** in tightening financial conditions and bringing inflation down fast. Central banks may be forced into more radical action in late 2023.
- **Growth remains healthy while inflation stays higher for longer**.
- **Policy Hikes:** Fed Funds Rate to **5%**
- **10-Year U.S. Treasuries**: **6%** as the **curve steepens**

STAGFLATION SHOCK (60%)

- **Inflation persists**. The commodities shock puts continued pressure on prices from Russian sanctions and Russia's weight in energy supply to Europe.
- **Central banks tighten aggressively** to rein in inflation expectations.
- **Demand is destroyed** from a loss of purchasing power and higher interest rates. The **adverse growth impact** on Europe is much stronger than the U.S., given energy dependence on Russia. However, higher global energy prices weaken the U.S. consumer, too.
- **With inflation well above target and aggressive policy tightening, Europe risks a recession, the U.S. a sharp slowdown**.
- **Policy Hikes:** Fed Funds Rate tops out above 4% and may need to hold until inflation heads convincingly lower
- **10-Year U.S. Treasuries**: Settle at **2.5%** in 12-18 months

Scenario Matrix—Economy

		Steeper Slide		Higher for Longer		Stagflation Shock		
	Annual Averages	**2022**	**2023**	**2022**	**2023**	**2022**	**2023**	**Baseline scenario**
U.S.	Growth	1.5%	0%	2.5%*	2.5%*	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	3%*	-1%	3%*	2.5%	3%*	-1%	Uncertainty about the **energy shock** and its policy response translate into an uncertain growth-inflation path. Our baseline assumes energy rationing and little ability for policy to rapidly smooth the impact on the economy.
	Inflation	8%*	2%	8%*	3%	8%	5%	
	Unemployment	7%	10%	7%*	8%	7%	10%	
Japan	Growth	1.5%	0%	2%*	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%	3%*	4%*	4.5%	3.5%	4%*	**Loose fiscal policy is likely to combine with a moderate easing of financial conditions**, but more will be needed to boost growth. The zero-COVID policy is likely to be loosened towards year end.*
	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 September 12, 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

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's tightening has little effect*	Fed Funds Rate: Tops out above 4% and may need to hold until inflation heads convincingly lower*
ECB	Growth and inflation falter faster than expected, making the ECB pause hikes at year-end*	Better-than-expected growth allows the ECB to hike aggressively well into 2023, bringing the policy rate above 2%*	The ECB front-loads rate hikes to 2¼% by end Q1 2023 and then stops to let it pass-through in a recessionary environment*
BOJ	Policy rate stays negative; yield curve control (YCC) is kept in place 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*
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	Gradual easing, focusing on window guidance to promote credit growth. Further policy rate cuts are unlikely*

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Scenario Matrix—Market Implications

	Steeper Slide	*Higher for Longer*	*Stagflation Shock*
U.S. Rates	10Y UST around 2%; curve slightly inverts. Supportive for government bonds*	10Y UST settles at 6%, led by breakevens; curve steepens. TIPS should outperform nominals*	10Y UST tops above 4% before settling and may hold to ensure inflation is heading decisively lower*
Corporate Credit	Good for duration, but likely negative for High Yield*	Positive for credit, especially High Yield. Also positive for loans and floating rate credits*	Duration may suffer as rates edge higher, but there will be attractive entry points for credits with strong balance sheets*
Equities	Negative risk assets, although Quality may be more resilient*	Weaker returns on contracting multiples, but likely better outlook for financials and commodity-linked names*	Quality likely to outperform Value. Positive for energy and firms with pricing power. U.S. looks better than Europe*
FX	A more vulnerable U.S. economy will likely weaken the dollar at first, although losses may be limited as safe haven flows return	Bullish dollar as US growth outperforms other regions and central banks lag the Fed's hikes	Supportive USD in flight to safety and rate differentials. Negative for the euro and yen*
Commodities	Negative as global growth slows*	Healthy global activity should keep prices elevated*	Selective support amid USD strength; positive energy on persistent supply-demand imbalance*

The above represent the views of Barings as of September 12, 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 July

WHAT'S NEW

- **A month of moderating U.S. inflation**
- **Gasoline prices have turned lower**
- Even with Nord Stream 1 cuts, **European gas storage** levels are high enough for winter, reducing risks of drastic **rationing**
- **Extreme weather** has weakened support of non-fossil energy sources, putting pressure on food prices and creating damage in many countries, including EMs
- **Surprise PBOC policy rate cuts** in China amid mounting headwinds from zero-COVID policy and property sector reforms
- The **new U.K. government**, led by Liz Truss, has promised tax cuts and an energy-price freeze, helpful for inflation and household finances but challenging for the public budget

WHAT WE LEARNED

- ECB has become worried about inflation expectations de-anchoring and is **frontloading rate hikes**
- European governments are enacting substantial **fiscal packages supporting households** through the energy crisis
- Biden administration was able to deliver a big **spending package** on climate, health costs, and student loans
- **Corporate results** remain resilient
- **OPEC** cuts output to keep oil prices high
- Chinese authorities express concern about **downside risks to growth,** de facto abandoning its 2022 growth target and hinting at further fiscal stimulus

WHAT WE ARE HEARING FROM OUR TEAMS

- Few signs that defaults will meaningfully rise over the next year, given **strong corporate balance sheets** and liquidity
- The energy shock is creating **winners and losers** as some European companies need to curb production while others enjoy less competition
- Opportunities continue in **industrial real estate**, although office space still looks challenging
- Very **difficult market environment for EM** because nearly every sovereign is challenged. This unique crisis means history will be less of a helpful guide

WHAT WE ARE WATCHING

- **European gas supplies and fiscal response**
- **U.S. wage dynamics**
- **U.S. midterm elections and implications for fiscal policy**
- Whether **quantitative tightening** leads to a liquidity crunch
- **Diverging signals from commodities,** as fundamentals support higher prices but markets price in recession
- **China's 20th Party Congress** on October 16, as it will likely usher in a new policy cycle as leadership is reshuffled and Xi Jinping gets a third term

Monthly Spotlight: Will QT Trigger a Financial Crisis as Growth Slows?

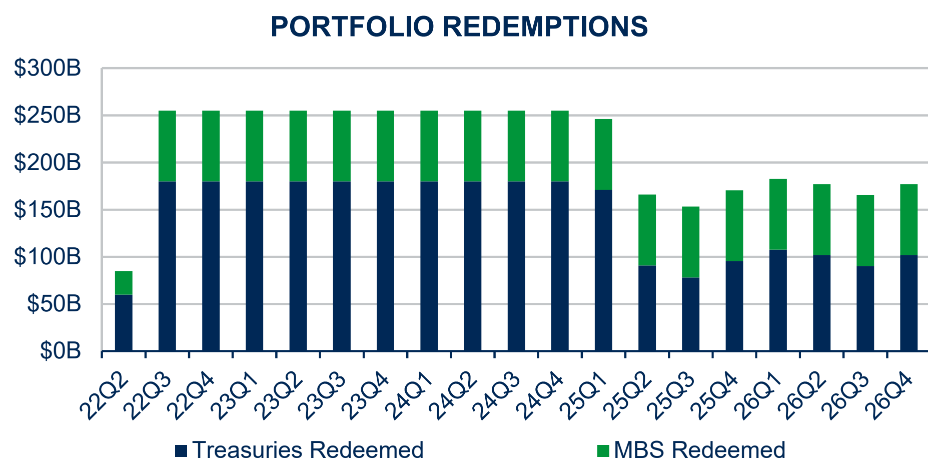
Policy rate hikes are the Fed's primary tool to control inflation, but also running in the background is the Fed's quantitative tightening (QT).

The Fed has only simultaneously had to raise interest rates while unwinding the balance sheet once, in 2017, but then had to abort abruptly when the repo market broke. **So not only is uncertainty high around their concurrent impact, the limited historical precedent also suggests the Fed will likely proceed with extreme caution.**

The shrinking process involves a growing quantity of securities that would be allowed to mature without reinvestment. That amount will top out in September at roughly double the pace compared to 2017, with $60 billion in U.S. Treasuries and $35 billion in Mortgage Backed Securities (MBS) for a total of $250 billion maturing every quarter.

There are no planned active sales from the Fed's balance sheet for now, so the impact of QT will likely be felt the most during Treasury auction days, when a larger share of Treasury issuance going forward will have to be absorbed by the public.

Critical to determining the pricing impact will be assessing the appetite of any marginal buyer.



Source: Bloomberg, Piper Sandler. As of September 8, 2022.

The Fed was a non-economic buyer, intervening to stabilize rates rather than earn a profit. Alternative buyers filling the gap may now require more yield to compensate them for perceived risks, and this may only continue to rise given the inflationary backdrop. As a result, interest rates may have to go up notably to make ownership attractive from a total return perspective, **likely materializing as higher term premiums and real yields.**

Helping potentially smooth this process, however, is the expectation that Treasury issuance shrinks this year amid a historic contraction in the U.S. budget deficit. That said, even with falling issuance, auctions will still remain larger than they have been in recent history. And with both domestic and foreign banks unlikely to absorb the marginal Treasury supply given low-risk budgets and higher hedging costs, most of the burden will likely fall on households sitting on excess bank deposits.

As for the MBS market, the impact may be muted for now. The Fed's MBS portfolio's weighted average coupon is roughly 3.16%, and with 30-year mortgage rates reaching as high as 6%, reductions in MBS debt due to prepayment will likely come in well below the Fed's stated redemption schedule.

Finally, the outlook will likely revolve around the Fed's commitment to this tool. And based on its communication so far, **if signs of instability start developing, QT will likely stop.**

Looking ahead, rising recessionary fears will likely be a large factor in determining interest rates, but **expect real yields and term premiums to continue to trend higher even if nominal yields trend lower.**

For the unabridged discussion of this topic, see Christian Floro's Research Note, "Will the Fed's QT Trigger a Financial Crisis as Growth Slows?".

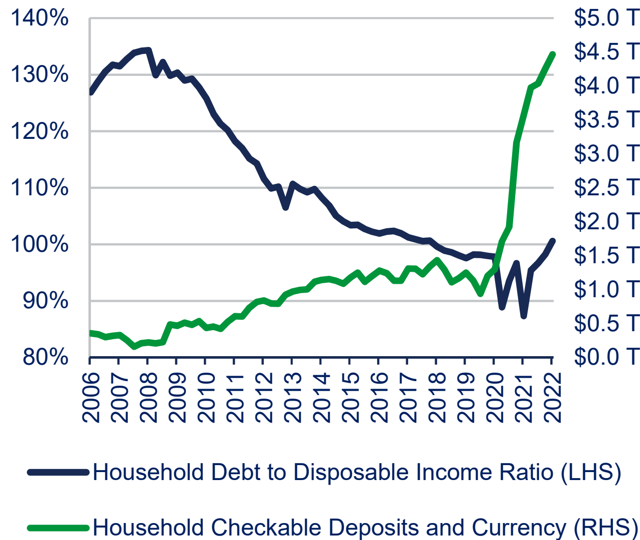
For additional analysis on how QT may impact the inflation outlook, see Ricardo Adrogué's Research Note, "Why Quantitative Tightening Could Make Quick Work on Inflation—Speed Trap Ahead!".

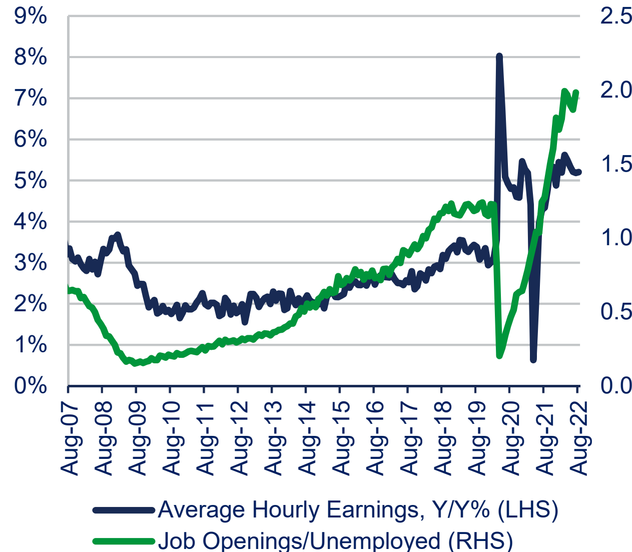
United States

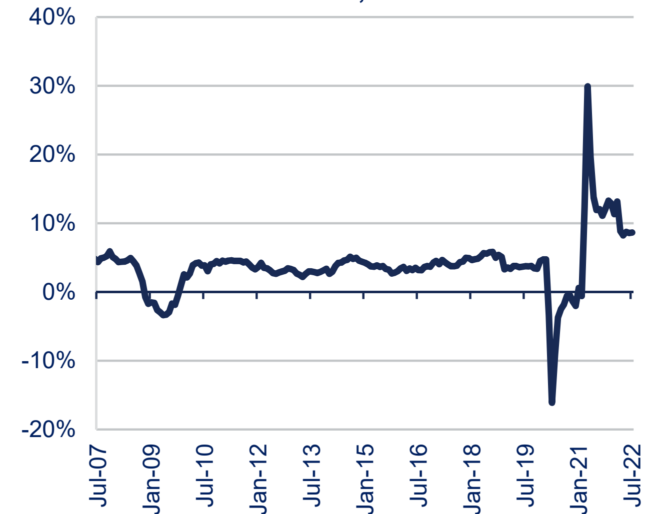
HOUSEHOLD BALANCE SHEETS are healthy…

…and NOMINAL WAGES are growing at a fast clip as labor remains tight.

With the rise in credit, shoppers continue SPENDING despite higher prices.







- Household balance sheets are very strong. While credit is rising from very low pandemic levels, household debt as a share of disposable income remains low.
- Consumers still have ample excess savings on aggregate. Looking across income groups, all but the lowest 20% of households—which account for only 9% of total spending—still have more savings than prior to COVID.

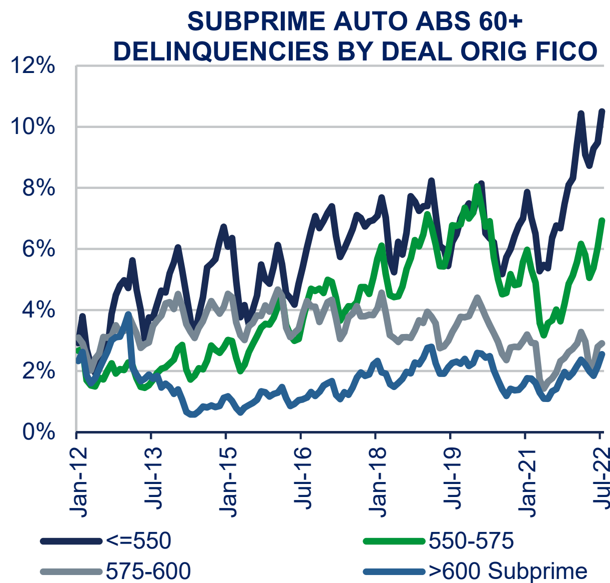
- The labor market remains very tight as demand for workers has proven resilient even in the face of tightening policy. Open jobs unexpectedly increased in July, and there are now two open jobs per unemployed person—matching the previous peak.
- While M/M growth in average hourly earnings eased slightly in August, nominal wage growth remains very elevated at 5.1% Y/Y—much higher than is consistent with the Fed's inflation target.

- Strong nominal wage growth, rising credit, elevated net worth, and savings buffers allow consumers to continue spending despite higher prices, supported corporate earnings and profit margins, so far.
- Nominal spending growth remains well-above historical levels, and spending continues to rise even when adjusting for inflation.
- Strong demand is allowing companies to continue to pass on input costs, even if to a lesser degree than a few months ago.

Source: Bloomberg, Haver. As of September 7, 2022.

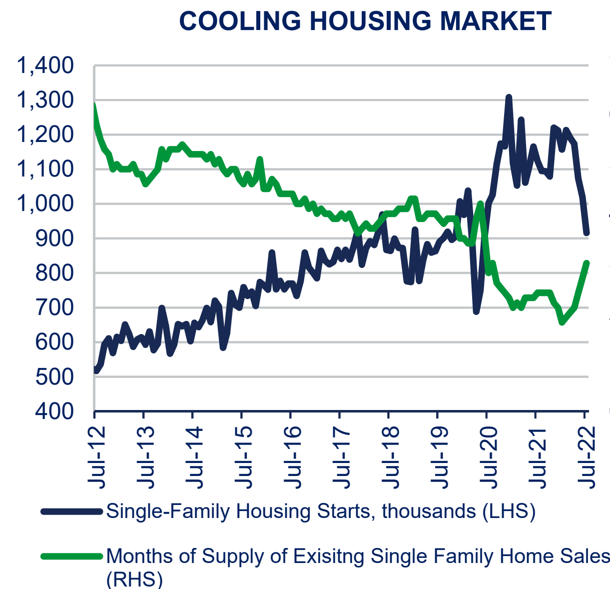
United States

Cracks emerged in the LOWEST INCOME groups, but delinquencies remain low.



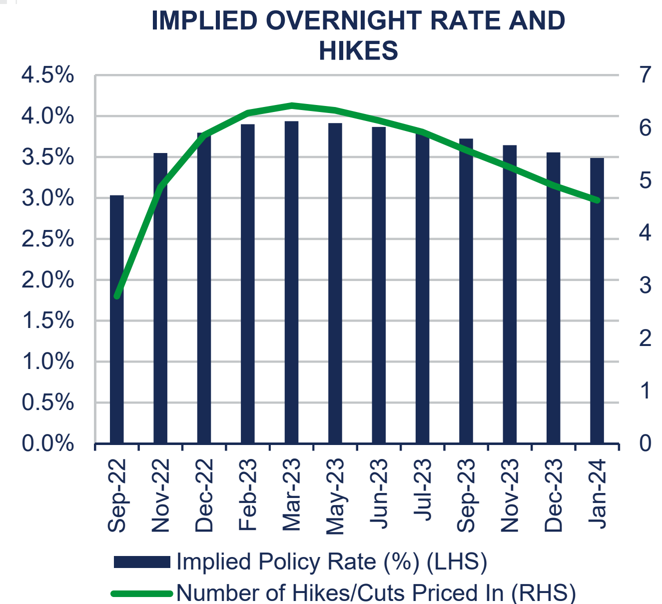
- Cracks emerged as subprime auto delinquencies rise, notably for the lowest of the subprime FICO cohort.
- Outside the lowest credit quality group—the smallest share of total spending—performance has held up, as delinquencies are at or below pre-COVID levels.
- Federal student loan payments are expected to resume in 2023, creating another challenge for consumers.

Weaker demand for HOUSING should weigh on GDP growth.



- Rising interest rates are weighing on housing demand, with starts down from two years of unsustainable levels. This will weigh on GDP growth and should slow house price appreciation.
- This may weigh on wealth, though the spending multiplier out of wealth is small.
- Undersupply of homes and demographics should support demand over the medium term and help avoid a GFC-style housing market collapse.

Strong demand and a tight labor market will see the FED hike more aggressively than currently priced-in.



- Despite some cracks in the housing market and among lowest-income consumers, overall demand remains strong and the labor market is too tight.
- Demand is still a large driver of current inflation pressures, which remain elevated historically, suggesting the Fed needs to hike more than is currently priced in to markets.
- This means there is more room for repricing of hikes, weakening in markets, and U.S. dollar strength.

Source: Bloomberg, Haver, and Morgan Stanley. As of September 7, 2022.

CONSENSUS FORECAST

- Consensus has downgraded growth closer to our baseline outlook for 2022 and 2023 and upgraded inflation closer to our baseline outlook for 2022. However, our central scenario continues to call for 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.
- Our baseline outlook sees a higher unemployment rate than consensus in 2023, given expectations for greater Fed rate hikes and slowing growth.

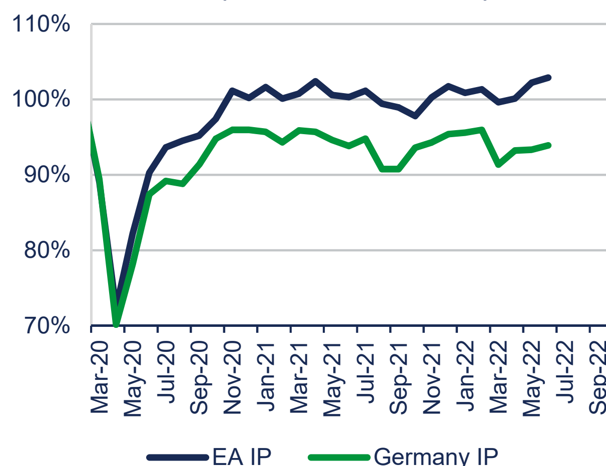
Economic Growth	9/7/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
Real GDP (Y/Y %)	1.7	2.3	-3.4	5.7	1.7 ▼	1.0 ▼
Inflation						
CPI (Y/Y %)	8.5	1.8	1.2	4.7	8.0 --	3.7 ▲
Core PCE (Y/Y %)	4.6	1.7	1.4	3.3	4.8 ▲	3.2 ▲
Labor Market						
Unemployment (%)	3.7	3.7	8.1	5.4	3.7 ▼	4.0 ▲
Rates						
Fed Funds	2.38	1.63	0.13	0.13	3.55 --	3.35 ▲
2Y Treasury	3.44	1.57	0.12	0.73	3.31 ▼	2.92 ▼
10Y Treasury	3.27	1.92	0.92	1.51	3.06 ▼	2.92 ▼

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of September 7, 2022. (E)—Bloomberg private market consensus estimates.

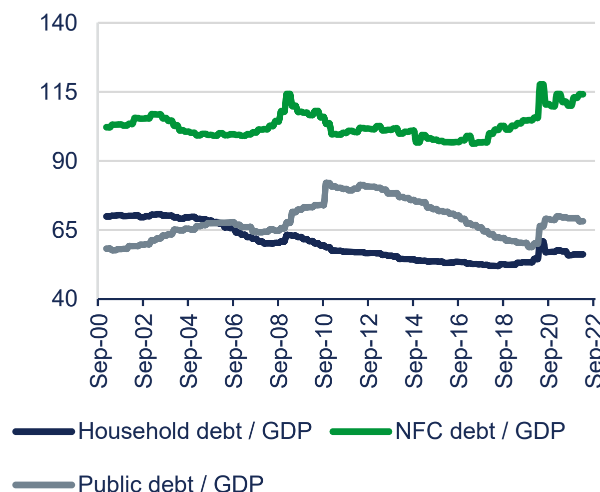
Europe

GERMANY is suffering from a series of adverse shocks.



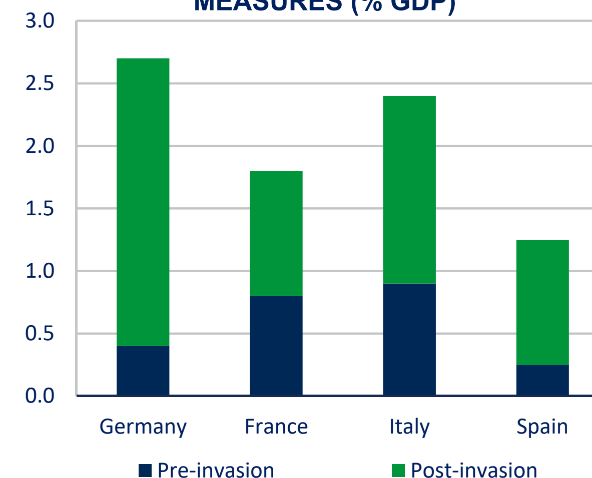
- Germany is the major EU economy most exposed to the energy shock, with the biggest industrial base and highest dependency on Russian gas.
- COVID-related supply chain disruptions had already dented the outlook for German companies.
- Germany finds itself unusually lagging other euro area economies: industrial production is 8% below pre-COVID levels and 1% above the euro area as a whole.

ROCK-SOLID BALANCE SHEETS are helping smooth the impact.



- The good news is Germany has ample room to maneuver and smooth the impact of these adverse shocks.
- It has by far the lowest public debt of G-7 countries and its household balance sheet is rock solid.
- European corporates increased leverage during the pandemic thanks to highly subsidized loans. They also built liquidity, with a ratio of liquid assets to short-term liabilities hitting 123%, a record high and 10% more than pre-COVID.

FISCAL POLICY is already doing that.

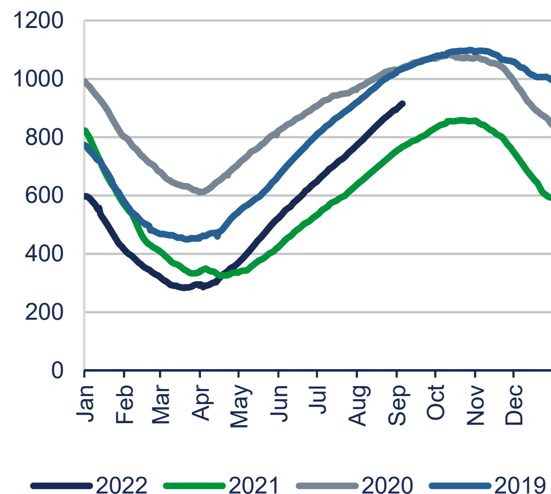


- The German government is using its fiscal space to support households and firms through generous energy-focused packages.
- The €65 billion (1.8% of GDP) support package announced in September has made Germany the EA country with the strongest fiscal support to households.
- Fiscal policy will smooth the economic impact of the war, although a recession will hardly be avoidable if Russian gas supplies stop and domestic rationing for industry or households becomes necessary.

Source: Bloomberg and Haver. As of September 7, 2022.

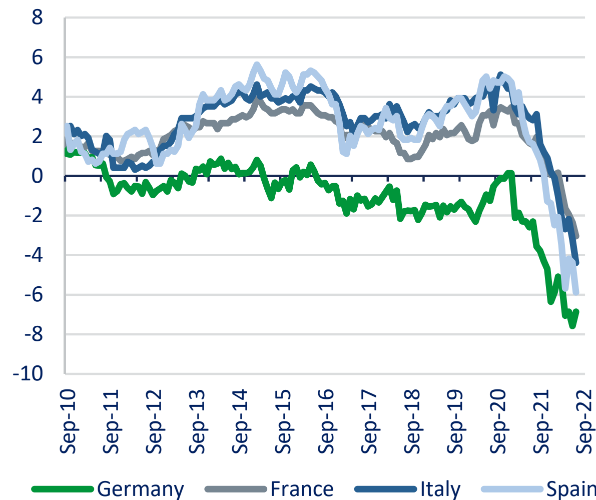
Europe

Europe has come close to its 90% GAS STORAGE target.



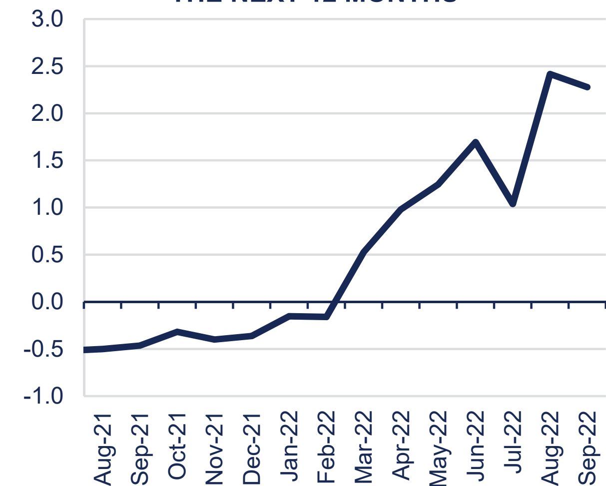
- Europe will likely get through winter without harsh rationing—unless it wants to keep some storage for weather contingencies in spring.
- Some rationing is thus likely but will have a less-severe impact on the economy than previously feared.
- Questions remain about gas needs after winter, when most storage will likely have been used. Gas prices should remain very elevated well into 2023.

REAL RATES show that financial conditions will have to tighten more.



- Net of current inflation, interest rates prevailing across the euro area are low and negative: financing conditions are still accommodative.
- Activity has held up so far, with Q2 growth up 0.8% from Q1 (4.1% Y/Y), driven by the post-pandemic catch-up.
- When current tailwinds from the post-COVID reopening and tourist season dissipate, a deep recession may force the ECB to stop hiking and assess the damage.

THE ECB may tighten policy considerably more than previously expected.



- The ECB was expected to look through the energy-driven inflation spur and focus on the fragile euro area economic outlook.
- Higher-than-expected inflation and rising medium-term inflation expectations have convinced the ECB to frontload policy rate hikes.
- Markets are now pricing a faster path to the terminal rate of 2.25%.

Source: Bloomberg and Haver. As of September 7, 2022.

Europe

CONSENSUS FORECAST

- Our central scenario of a complete halt of Russian gas supplies to Europe is becoming a reality, making rationing or, at the very least, demand management unavoidable, creating consequences for manufacturing and growth. Inflation will also be boosted, delivering the ECB an ever-worsening trade-off between deeper recession and higher inflation.
- Monetary policy will not be able to control this situation without coordination with fiscal policy. Fortunately, signs of active management of demand shocks from fiscal policy are already showing.

Economic Growth	9/7/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
EZ Real GDP (Y/Y %)	4.1	1.6	-6.1	5.2	2.8 ▲	0.7 ▼
U.K. Real GDP (Y/Y %)	2.9	1.7	-9.3	7.5	3.5 ▲	0.0 ▼
Inflation						
EZ CPI (Y/Y %)	9.1	1.2	0.3	2.6	8.0 ▲	4.3 ▲
U.K. CPI (Y/Y %)	10.1	1.8	0.9	2.6	9.3 ▲	6.8 ▲
Labor Market						
EZ Unemployment (%)	6.6	7.6	8.0	7.7	6.8 --	7.0 ▲
U.K. Unemployment (%)	3.8	3.8	4.5	4.6	3.9 --	4.3 --
Rates						
EZ Central Bank	0.50	0.00	0.00	0.00	1.50 ▲	1.65 --
EZ 2Y Note	1.09	-0.61	-0.72	-0.64	1.00 ▼	0.92 ▼
EZ 10Y Bond	1.57	-0.19	-0.57	-0.18	1.26 ▼	1.35 ▼
U.K. Central Bank	1.75	0.75	0.10	0.25	2.55 ▲	2.30 ▲
U.K. 2Y Gilts	2.98	0.53	-0.17	0.66	2.17 --	1.71 ▲
U.K. 10Y Gilts	3.03	0.82	0.19	0.97	2.21 ▼	1.88 ▼
Currencies						
EUR/USD	1.00	1.12	1.22	1.14	1.00 ▼	1.08 ▼
GBP/USD	1.15	1.33	1.37	1.35	1.16 ▼	1.24 ▼

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.
Source: Bloomberg. As of September 7, 2022. (E)—Bloomberg private market consensus estimates.

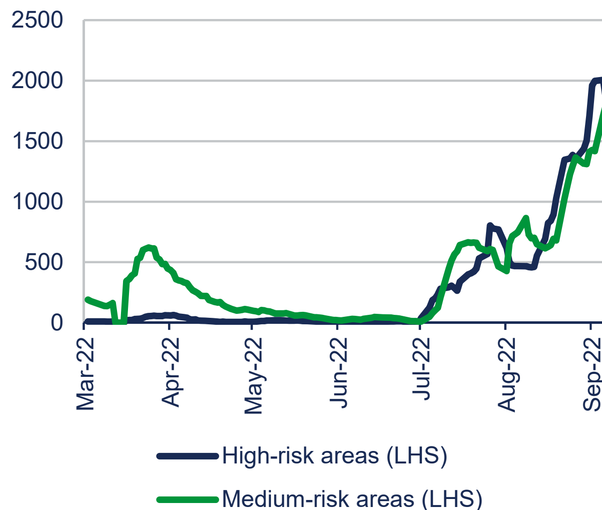
Asia Pacific

China's ZERO-COVID POLICY is restraining any upside to the economic outlook…

…as PROPERTY SECTOR REFORM would likely lead to a lasting slowdown absent aggressive support.

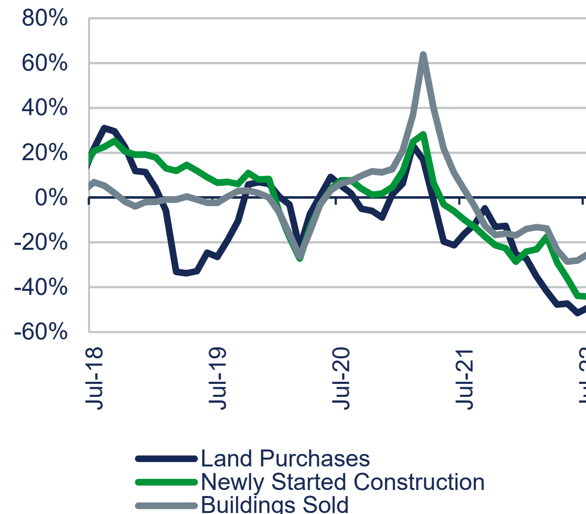
Both are leading to SIGNIFICANT UNCERTAINTY on the outlook, weighing on sentiment.

CHINA NUMBER OF HIGH- & MID-RISK TO COVID DISTRICTS



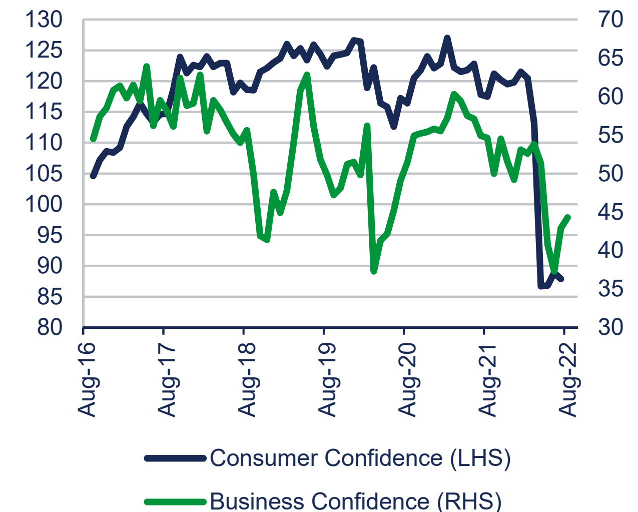
- The number of districts with medium or high risks to COVID have increased to 35% of GDP, the highest in 18 months.
- Policymakers have implemented frequent and harsh restrictions, locking down more cities in 2022 than 2021.
- The 20th Party Congress on October 16 could indicate the zero-COVID policy's future, which could loosen by year-end.

CHINA PROPERTY SECTOR ACTIVITY



- The property sector is among the most important in China, making up 30% of GDP and 60% of household assets.
- Containing the damage will no longer be enough as government bailouts and direct household support are needed to restore confidence in the sector.
- For now, authorities are either too hesitant or too cautious to respond forcefully given the Communist Party's stance on housing.

CHINA CONSUMER & BUSINESS CONFIDENCE

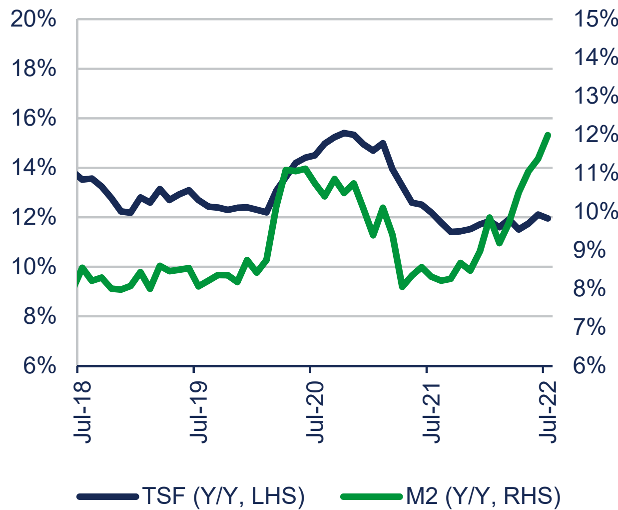


- COVID uncertainty, weak personal income and employment, and poor property sector optics are creating a huge drag on confidence.
- Recent exogenous factors including droughts, power shortages, and an earthquake in Chengdu are adding negative sentiment, at least temporarily.
- Household and business activity will likely remain very cautious absent clarity in the outlook, suggesting a short-lived economic rebound.

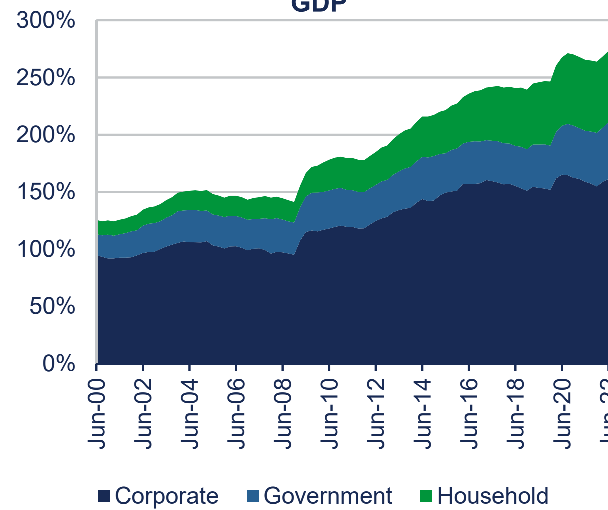
Source: Bloomberg, Haver and Goldman Sachs. As of September 7, 2022.

Asia Pacific

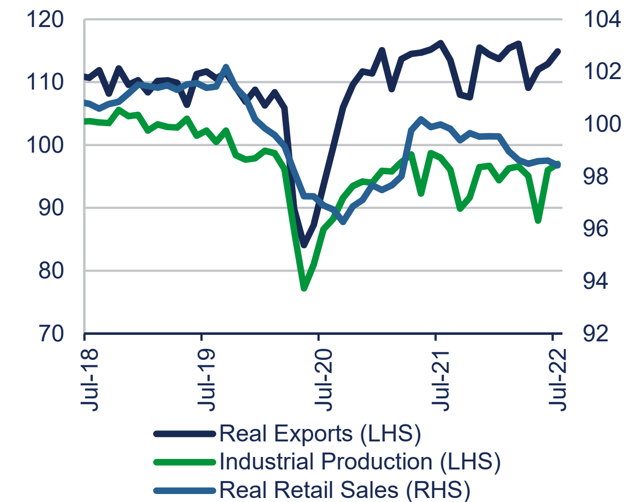
MONETARY POLICY, while still supportive, will likely take a back seat for now…	**…as FISCAL POLICY ramps up in an attempt to stabilize growth.**	**Japan's sluggish growth rebound and WEAKENING GLOBAL GROWTH will only add to headwinds.**



- Monetary policy has likely hit its limit as it cannot stimulate further credit growth. This is evident in total social financing (TSF) growth coming in much slower than M2 money growth.
- Diminished confidence and poor sentiment mean households and corporates are reluctant to take out credit.
- Outside rate cuts, structural policies like window guidance to increase loan growth should be effective tools going forward.



- Fiscal policy will be the main support tool in the next few quarters, likely materializing as infrastructure spending.
- Policy uncertainty may start to decline after the 20th Party Congress as authorities refocus attention on shoring up growth.
- Debt sustainability concerns could be a key constraint going forward. Total debt to GDP has ballooned nearly 30ppt since the start of the pandemic, primarily led by government borrowing.



- Domestic demand has faced headwinds from extended periods of pandemic-related restrictions and elevated prices.
- Despite production constraints from supply chain issues, external trade has been a positive driver to growth in Japan.
- As global growth slows, expect this tailwind to dissipate. Fiscal policy may also be less supportive as it shifts from increasing public investment to providing subsidies to households to counter rising prices.

Source: Bloomberg and Haver. As of September 7, 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 stickier inflation as well.
- We remain cautious on 2022 growth in China. Both upside- and downside-risks will likely be determined by fiscal policy's ability to provide much-needed support. Upside-risks to inflation are also possible, given China's large exposure to food in CPI.

Economic Growth	9/7/2022	12/31/2019	12/31/2020	12/31/2021	2022 (E)	2023 (E)
Japan Real GDP (Y/Y %)	1.1	-0.4	-4.7	1.8	1.5 ▼	1.6 ▼
China Real GDP (Y/Y %)	0.4	6.0	2.2	8.1	3.5 ▼	5.2 --
Inflation						
Japan CPI (Y/Y %)	2.6	0.5	0.0	-0.3	2.1 ▲	1.3 ▲
China CPI (Y/Y %)	2.7	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	-0.08	-0.13	-0.13	-0.09	-0.06 --	-0.04 --
Japan 10Y Bond	0.24	-0.02	0.02	0.07	0.22 ▼	0.22 ▼
China Central Bank	4.35	4.35	4.35	4.35	4.30 --	4.30 --
China 2Y Note	2.01	2.63	2.71	2.36	2.08 ▼	2.17 ▼
China 10Y Bond	2.62	3.13	3.14	2.77	2.73 ▼	2.78 ▼
Currencies						
USD/JPY	143.76	108.61	103.25	115.08	135.00 ▲	125.00 --
USD/CNY	6.92	6.98	6.52	6.38	6.90 ▲	6.72 ▲

Arrows indicate consensus estimate change compared to one month ago

Note: Unemployment figures are annual averages.

Source: Bloomberg. As of September 7, 2022. (E)—Bloomberg private market consensus estimates.

Central Scenario: Stagflation Shock

STAGFLATION SHOCK (60% ODDS)

Inflation persists. This is a commodities shock for the history books. Russian sanctions disrupt energy supplies 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 limited trade with Russia. However, the U.S. slows down too, 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, for now.

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.

Conditions
- Full embargo on Russian energy exports
- Prolonged war in Ukraine

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

Scenario risks
- Rapid deterioration of demand
- Complete change of the policy toolbox

The above represent the views of Barings as of September 12, 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 holds up in advanced economies, while supply side disruptions and the energy shock keep inflation from slowing down much. Central banks tighten financial conditions to tame prices, but to little effect because demand has grown more insensitive to prices, due to high savings and ongoing fiscal support. This provides firms with pricing power to pass-through higher input costs to consumers. Banks have space to lend, helping the economy buffer rising inflation. Growth remains positive while inflation stays higher for longer.

After the initial impact, the Ukraine invasion continues to deliver an inflationary shock globally. Energy prices and headline inflation stabilize but don't fall much in 2023.

Consumption proves more resilient than expected. Households saved a large share of fiscal payouts in 2021 and have become less sensitive to prices. Governments provide a number of tax cuts and subsidies to reduce the impact of higher energy prices. The reopening and a good summer season in Europe supports services through fall and winter. China learns to minimize the economic costs of lockdown measures and activity bounces back.

Central banks tighten financial conditions but their tools prove ineffective in reducing demand enough to match a still constrained supply. Supply-side disruptions related to COVID and the war continue to exert meaningful inflation pressures that central banks are not equipped to control. A strong dollar increases commodity inflation for commodity-importing jurisdictions, complicating central banks' already difficult task.

Beyond the horizon of this scenario, the risk of a much more severe recession looms as central banks will be forced to tighten policy for longer and fiscal authorities must consolidate their finances.

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

Conditions

- Mixed results from energy embargo on Russia
- Substantial fiscal support for energy-poor households
- Central banks surprised by consumption strength

Indicators

- Fiscal spending
- Central bank signalling
- Inflation expectations and wages
- Solid consumer confidence and expenditures

Scenario risks

- Confidence hit from the war and/or energy shock
- Markets questioning central bank credibility

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Alternative Scenario: Steeper Slide

STEEPER SLIDE (20% 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. Inventories that companies accumulated for the post-pandemic boom prove to be excessive. 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 reduce consumers' ability to borrow in an effort to smooth the impact of lost purchasing power. **In the absence of commensurate wage growth, demand naturally falls.**

Firms find themselves with excess supply relative to restrained demand. As 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) energy prices stay 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 eventually forced to reverse course. Some central banks 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 and curve may invert

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

Indicators to watch
- Household balance sheets
- Wage negotiations

Scenario risks
- Resilient consumer demand

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As of June 30, 2022.