10 June 2022

RESEARCH NOTE

A Scenic But Treacherous Trail

Matteo Cominetta, London

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.

These materials are being provided on the express basis that they and any related communications (whether written or oral) will not cause Barings to become an investment advice fiduciary under ERISA or the Internal Revenue Code with respect to any retirement plan, IRA investor, individual retirement account or individual retirement annuity as the recipients are fully aware that Barings (i) is not undertaking to provide impartial investment advice, make a recommendation regarding the acquisition, holding or disposal of an investment, act as an impartial adviser, or give advice in a fiduciary capacity, and (ii) has a financial interest in the offering and sale of one or more products and services, which may depend on a number of factors relating to Barings' business objectives, and which has been disclosed to the recipient.
OTHER RESTRICTIONS:
The distribution of this document is restricted by law. No action has been or will be taken by Barings to permit the possession or distribution of the document in any jurisdiction, where action for that purpose may be required. Accordingly, the document may not be used in any jurisdiction except under circumstances that will result in compliance with all applicable laws and regulations.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.
Any information with respect to UCITS Funds is not intended for U.S. Persons, as defined in Regulation S under the U.S. Securities Act of 1933, or persons in any other jurisdictions where such use or distribution would be contrary to law or local regulation.

22-2228906