

A Scenic But Treacherous Trail

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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

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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.

Policy makers 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.

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