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RESEARCH NOTE

# Unwavering Resolve

*Christian Floro, New York*

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.

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