SLOWING

Market volatility has picked up of late as investors assess the outlook for global growth, inflation and monetary policy. The S&P 500 has failed to gain traction as the 10-year Treasury yield has moved from 2.9% to 3.2%. The root cause of the uncertainty remains the outlook for inflation, and its resulting impact on monetary policy and growth. Central bank policy is frequently described as working with a lag and major central banks are early in their hiking campaigns – but we think this understates its impact. As shown below, financial conditions – a broad measure including interest rates, credit spreads, equity valuations and exchange rates – have tightened much more than average over the prior five rate hike cycles.

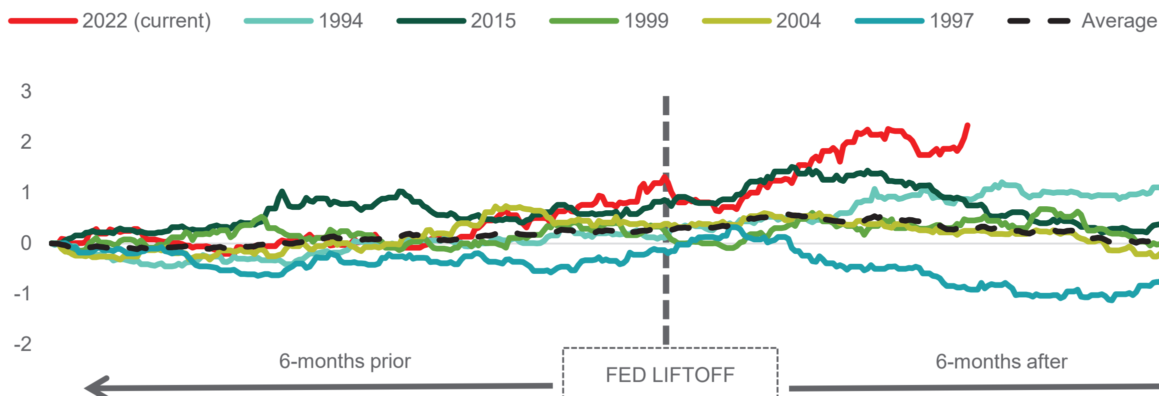
We now expect modestly disappointing growth in the U.S. over the next year – joining our cautious outlook toward European and Chinese growth – as the impact of tightening financial conditions takes hold. We have also seen the savings rate of the U.S. consumer fall to just 4.4% – the lowest level since the global financial crisis and down from 33% at the height of the pandemic. No doubt, this is a result of wage growth of just 5.2% over the last year while consumer prices have jumped 8.6%. Such a drawdown in savings will likely limit growth in consumer spending over the next year, as will financial market volatility. We do expect slowing growth to start to reduce pressure on inflation globally over the next year. But we see limited evidence of this so far, as May U.S. consumer prices exceeded estimates and European inflation of 8.1% was also above expectations. This underpins our risk case of Sticky Inflation, where stubbornly high inflation leads to more hawkish central bank policy.

Our base case calls for slower growth globally, as inflation and higher interest rates join risks from Ukraine and the Chinese zero-COVID policy to hamper growth. We are also focused on central banks' management of inflation expectations. In response to our more cautious outlook for U.S. growth, we made one change in our global policy model this month. We reduced our recommended allocation to U.S. equities by 2%, reinvesting in the more defensive global listed infrastructure asset class. Equity markets have adjusted significantly to higher interest rates and the more uncertain growth outlook. Looking out over the next year, we favor real assets like natural resources and global listed infrastructure which are benefiting from supply shortages and are an inflation hedge. We also continue to like high yield bonds, where we think the current yield of 7.8% is attractive as we think the market is overstating the odds of recession in 2023.

A QUICK TIGHTENING

Financial conditions, which directly impact future growth, have tightened the most of the last six rate hike cycles.

U.S. FINANCIAL CONDITIONS: % CHANGE INDEXED 6 MO. PRIOR TO FED LIFTOFF



Source: Northern Trust Asset Management, Bloomberg, Piper Sandler Cornerstone, Goldman Sachs. Fed liftoff is the date of the first Federal Reserve policy rate hike for hiking cycles dating back to 1994. Data as of 6/10/2022.

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BASE CASE

Reaching Slower Growth Equilibrium

The global growth outlook has shifted downward given higher consumer costs, the recent move higher in interest rates (which has flowed into mortgage rates, etc.) and the continued uncertainty in Russia and China. But markets have also significantly adjusted to this new reality.

Managed Inflationary Expectations

While the Fed and other central banks missed the "inflation is not transitory" call, they have done a good deal over the past six months to reset rates higher and stabilize investor inflation expectations. Looking ahead, investors will focus on how quickly and orderly inflation falls from current levels.

RISK SCENARIOS

Eastern Threats

Ukraine has stabilized somewhat but knock-on effects (food/energy shortages) must be watched; China is lifting lockdowns but less effective vaccines suggest untenable case spikes could prompt new restrictions.

Sticky Inflation

Inflation stays stubbornly high and doesn't follow the fairly smooth downward trajectory investors anticipate. Central banks are then forced to take a much more hawkish approach to the current policy unwind.

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