CONFLICT

Inflation, along with the second order negative impact on growth, remain top of mind for markets. The U.S. June Consumer Price Index (CPI) print of 9.1% year-over-year (y/y) was the second consecutive negative surprise. As shown below, there is a real conflict between the current high level of inflation and what the market is pricing in for inflation over both the near and long term. While core CPI has declined sequentially for three months in a row, the rate of decline has been slower than market expectations. Meanwhile, expectations for inflation over the next two years have dropped from a peak of 4.9% to 2.9%. Market expectations for inflation longer term (roughly 2027-2032) have declined to 2.1%. The second order effect of inflation on growth is increasingly of concern to investors. We see conflict on this front between real-time data and financial market leading indicators.

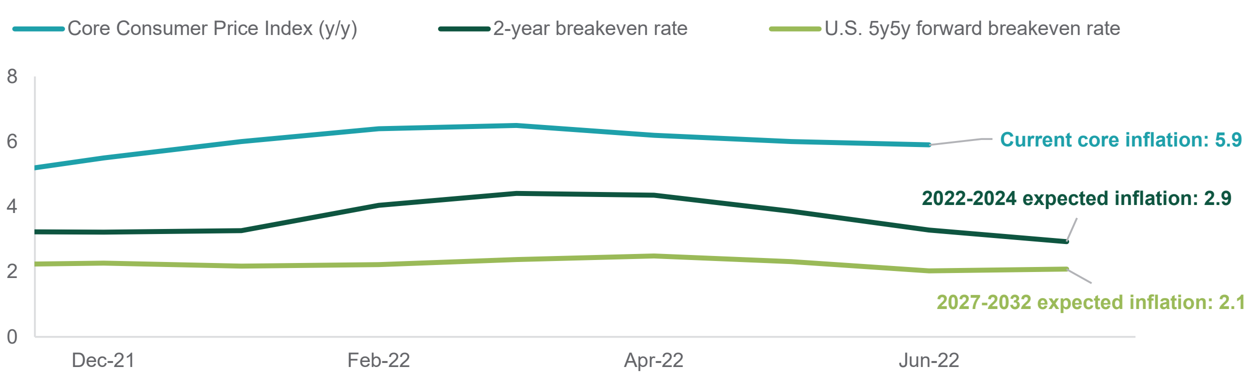
Growth data in the U.S. has been generally solid, including critical areas like consumer spending and capital expenditures. Nonetheless, GDP in the first quarter fell 1.6% due to weak exports and declining inventories. Some economic forecasting models see second quarter GDP flirting with zero growth, which would lead to a "technical" recession. For a full-blown recession to take hold, we would expect to see much broader declines in economic activity, especially in areas like the labor markets and capital spending. Yet, indicators like the yield curve, high yield spreads and consumer confidence are flashing warning signs. As a result, we now estimate a 50%/50% probability of a U.S. recession over the next 18 months. Importantly, we think any recession is more likely to be of the shallow, cyclical type as opposed to a deep, structural recession.

We continue to focus on Eastern Threats as a primary risk case. We have been more cautious on European growth, due to the impact of the Russia/Ukraine war on activity and the increased uncertainty about European energy supplies. This will likely lead to a European Central Bank that is more dovish than the Fed, especially as it focuses on controlling interest rate differentials amongst its leading economies. Chinese growth has been disappointing, with the continued growth drag from Covid in China leading to some increased fiscal support in recent months. In response to our more cautious economic outlook, we made another change in our Global Policy Model this month as we reduced our recommended position in Natural Resources by 2%, allocating the proceeds to Cash. Overall, this leaves the Global Policy Model modestly underweight traditional equities, modestly overweight real assets, overweight high yield bonds and underweight investment grade bonds. Market volatility is likely to remain high until clarity is reached on the Fed's rate cycle, and the resulting impact on economic growth.

TIMING IS EVERYTHING

While inflation levels are high today, investors anticipate inflation will come down materially as time passes.

YEAR-TO-DATE U.S. INFLATION DATA (%)



Source: Northern Trust Asset Management, Bloomberg. Data through 7/14/2022 (most recent CPI as of 6/30/2022).

BASE CASE

50/50 on Recession

The global growth outlook has shifted downward given higher consumer costs, recent monetary policy restrictiveness (which has flowed into mortgage rates, etc.) and continued uncertainty in the East. At this point, the odds of continued economic expansion are equal to the odds of (modest) recession.

Inflation-Focused Fed

Versus the previous Fed cycle (balancing much less inflationary pressure with a fragile economy), today's Fed – this time less swayed by market action – will keep hiking until inflation is contained.

RISK SCENARIOS

Eastern Threats

Ukraine has stabilized somewhat but knock-on effects (food/energy shortages) must be watched; China lockdowns are still a threat and less effective vaccines suggest 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 quicker/more restrictive approach to the current policy unwind.

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