A more uncertain world - economic and financial decoupling: House View Q&A (Q2 2022)

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With the release of Aviva Investors' House View Q2 2022, Stewart Robertson (SR), senior UK and Europe economist, discusses the firm's current economic thinking and asset allocation views with Peter Smith (PS), multi-asset and macro investment director.

PS: In our 2022 Outlook we forecast above trend pace of growth. How has this thesis evolved over the past quarter?

SR: Recent events in Ukraine have highlighted the fragility of the global geopolitical and economic order. Russia's unprovoked attack on Ukraine has, first and foremost, resulted in a humanitarian crisis and our thoughts are with those impacted.

Russia's invasion of Ukraine, the resulting economic sanctions and knock-on impact of energy security are likely to have profound implications for the global economy for many years. Heading into 2022, we expected another year of well above trend growth across all major economies. While the magnitude of the shock to global energy and other commodities is still evolving, we have marked down global growth this year by around 0.5 percentage points, to a little below four per cent.

PS: What impact will the spike in energy and commodity prices have on the global economy?

SR: The impact of higher energy prices on household disposable income will be felt globally but will be even more acute in the UK and euro zone, where natural gas prices will be impacted by the uncertainty of Russian supply. Furthermore, income and activity will most affect economies that are net importers of oil and gas. This would again include the UK and euro zone, while potentially being modestly beneficial to the larger net exporters like Canada and Australia.

However, even with the larger impact on the euro zone, we still expect growth of around 2.5 per cent this year. There are risks on both sides of that projection, but they are skewed to the downside given the risk of higher energy prices.

PS: Inflation has hit 40-year highs: do we expect this to continue, or will central banks be able to get this under control?

SR: We have revised up our inflation outlook to reflect the recent shock to energy prices and upside surprises in goods inflation that have persisted for longer than anticipated. In the euro zone and the UK, inflation is expected to peak around seven or eight per cent the highest rates in over 30 years. Around half of the year-on-year increase can be attributed directly to energy prices.

In our central scenario, this contribution is expected to fall, reflecting the decline in the price of futures contracts for oil and gas. However, there is an unusual amount of uncertainty given the war in Ukraine, with the risk of further upside surprises in oil and gas prices.

In the United States, the peak in inflation is also expected to be around eight per cent, but the contribution from energy is smaller, at around two per cent. Inflationary pressures are more broad-based in the US, with both goods and services inflation ex-energy well above their average of recent decades, reflecting the strength of domestic demand, wage pressures and ongoing supply challenges.

PS: As we enter a new era of central bank policy, what are our expectations around rate hikes for the rest of 2022?

SR: We expect policy rates to rise markedly over the course of 2022. At the forefront of this will be the US, where we now expect the Federal Reserve to increase policy rates to around two to 2.5 per cent by the end of the year.

That is a much faster pace of rate hikes than previously expected, reflecting some pull-forward from our expectations for 2023. It also reflects an expectation of the Fed now needing to tighten policy by enough to become outright restrictive, thereby slowing growth to below trend in 2023/24. We expect the policy rate to peak around 3.5 per cent, but the range of possible outcomes is wide.

In the euro zone and the UK, a materially worse outlook in the trade-off between growth and inflation makes the monetary policy outlook even harder to assess. In both cases, there will be a strong desire to ensure high inflation rates do not become embedded in future wage and pricing decisions. At the same time, the impact on national incomes from the energy shock is expected to be a material drag on growth this year. Overall, we continue to expect further rate increases from the ECB and BoE, but those increases are likely to be slower than the Fed.

PS: Energy security and decarbonisation have come into sharp focus in recent months. Will we see a shift in developed governments policy around this area?

SR: The world's dependence on fossil fuels has been an uncomfortable truth for several decades, but at least momentum had been building in recent years towards the vital transition to renewables. The war in Ukraine has starkly exposed the duplicity of western nations who have relied heavily on imports of energy from Russia: it is now inevitable that energy security will become a critically important policy aim for all nations in both a short and a longer-term context.

The energy transition should eventually lead to lower prices, but it will be far from costless getting there and the process is almost certain to result in higher inflation.

PS: Will the Russia-Ukraine conflict lead to a shift in global international relations?

SR: Well before the COVID-19 pandemic and Russia's invasion of Ukraine, the tide of globalisation that had swept the world in recent decades was already changing. Momentum towards ever-closer integration was slowing and several elements of economic, social, commercial, and political theatre had started to resist that tide and move in different directions.

Recent events may act as a further accelerant to such change. Transitions associated with these shifts suggest the extended era of low inflation, suppressed economic and market volatility and easy financial conditions may be coming to an end. This could result in supply shocks, which have become more familiar in recent years, becoming as widespread as demand shocks.

PS: What keeps you awake at night?

SR: We highlight several risks in our House View; clearly we need to be concerned that the inflation genie is now out of the bottle. But the main worry is that the inflationary impulse broadens as expectations adapt upwards, leading to a more widespread acceleration in inflation.

Fiscal policy has come back into fashion in recent years, but there are limits to fiscal sustainability as it depends on well-known relationships between growth, inflation, interest rates, budget deficits and debt levels.

China also poses a level of concern with the possibility of a policy mistake as it faces a number of headwinds including continued stress in its property market, its zero COVID policy and the crackdown on large tech firms. Policy looks likely to remain supportive, but the growth target for the year of 5.5 per cent seems ambitious.

PS: How does all this impact our views on asset allocation?

SR: In general terms, we prefer to be overweight equities and underweight duration although we recognise a higher yield environment presents a more challenging outlook for equity markets. However, with growth expected to remain above trend this year – albeit slower than in 2021 – and corporate pricing power seemingly robust, we prefer to be modestly overweight equities in developed markets, with a more neutral view for emerging markets. Recent spread widening in credit markets has provided an opportunity to move from a preferred underweight to neutral.

PS: What's your view on equities given the headwinds we've spoken about?

SR: Supply shocks such as the global pandemic and its aftermath, compounded recently by the war in Ukraine, created a challenging environment for equities. They now also face an additional significant headwind in the form of a tightening cycle from global central banks.

That said, medium-term growth prospects are still reasonable as post-COVID-19 reopening eases supply side disruptions and benefits services and tourism. Rates are rising in an orderly fashion and companies are showing satisfactory pricing power; this adds support to maintaining a modest overweight exposure.

Under the hood, in both Europe and the US, higher real rates are a challenge to valuations in tech and other growth sectors, while rising interest rates and commodities favour banks, energy, and materials. The divergence between sectors is stark, and the trends have further to run. For emerging markets, we move to neutral as China's promises to support growth and to a less strict COVID-19 policy show alleviate downside risk.

PS: How have currency markets reacted to recent events?

SR: Despite the dramatic events and increased market volatility, the US dollar, the traditional currency of safety in uncertain times, has strengthened by less than two per cent in real terms. The Japanese yen, often another safe haven in times of stress, has depreciated more than six per cent year-to-date.

Across G10 currencies, economies linked to commodity prices have appreciated this year. The large and extended period over which we project the terms of trade shock to persist suggests increased appreciation pressure on currencies that benefit from exports and higher rates going forward.