Inflation fight raises recession risk: House View Q&A (Q3 2022)

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With the release of Aviva Investors' House View Q3 2022, Michael Grady (MG), head of investment strategy and chief economist, discusses our current economic thinking and asset allocation views with Jennie Byun (JB), multi-asset and macro investment director.

JB: Let's start with the overall growth picture. "Slowing growth" is the theme - are we still forecasting above trend growth?

MG: No. The combination of much higher inflation, war in Ukraine, ongoing energy (and other commodity) price shock and tighter monetary policy is not a growth-friendly one. High inflation is eroding real incomes for households, lowering consumption, elevated uncertainty is hurting investment, while global supply chains continue to be disrupted by post-COVID adjustments, war in Ukraine and China's ill-advised approach to the pandemic. For those reasons, we now expect global growth to be below trend for 2022 as well as 2023, with the risk of recession rising to close to 50 per cent.

In its June World Economic Outlook, the OECD downgraded its growth forecasts substantially. World GDP is now expected to increase by three per cent this year (previously 4.75 per cent) and 2.75 per cent in 2023 (previously 3.25 per cent). Some of the growth numbers for next year now look notably weak: euro zone 1.6 per cent, US 1.2 per cent and UK 0.0 per cent. Our own growth projections are similar, with stagnation risks for the UK and parts of Europe.

JB: The opening line of the House View publication notes inflation as the dominant driver of global macroeconomics and financial markets. How should we be evaluating the inflation outlook and risks?

MG: Although it is still a relatively recent phenomenon, high and rising inflation has now been with us for long enough to be described as a breakout. The supply chain issues have been well covered in previous publications, with supply curves becoming more inelastic across both the commodity complex, particularly energy, as well as in the labour market. If energy prices stabilise and if global supply chain disruptions ease, as we expect, then price pressures which have resulted from those earlier trends will fall or even reverse, driving inflation back down again. However, this will be a story for 2023 and "acceptable" levels will remain higher than in the past.

The risk is that recent experience may have let the inflation genie out of the bottle, and underlying inflation pressures and/or second-round effects take firmer root. There is evidence this is happening, especially in the US, where domestically generated price pressures have become an important part of the overall inflation picture. Such "conventional" inflationary overheating is less prevalent in most other developed nations, but is far from absent. This is the main concern for inflation-fighting central banks, with recent actions giving market participants faith they will be able to rein inflation in.

JB: On that topic, where do we see monetary policy moving from here and what are your projections for interest rate hikes across the major developed central banks?

MG: When we published our 2022 Outlook in December, we said it would be sensible and appropriate for financial markets to prepare for tighter monetary policy. At that time, such a view was bordering on controversial, with many market participants and commentators believing policy rates would be stuck near zero (or even below it) for a while yet.

Six months on, tighter monetary policy is a given. The previous mantra of gradualism has been replaced by "expeditious" plans to move policy to a restrictive setting. That has seen the Federal Reserve (Fed) raise rates in June by 75 basis points (bps), the largest increase since 1994. However, policy remains accommodative at current levels, and it has indicated that a further 200bps of rate hikes are likely by the end of the year to get policy into restrictive territory. Other central banks are also moving quickly, or planning to do so, including the European Central Bank (ECB), which has not raised rates in over a decade.

Within the US, we expect the policy rate to peak at just under four per cent by the end of 2023, but the range of possible outcomes is wide. In the UK, the Bank of England is torn between acting "forcefully" to tame inflation and adding to the growth headwinds and economic pain; we expect its policy rate to remain closer to two per cent. The ECB is poised to raise policy rates slowly and steadily. Whether it will push rates up to the one per cent projected for end-2022 by markets looks less certain. The Bank of Japan remains the outlier; changes to yield curve control could happen soon and would lead to higher yields but this may only happen at the end of Kuroda's term in early 2023.

JB: Recession fears have gripped markets lately, raising doubts on central banks' ability to curb inflation without strangling growth. Can it be avoided?

MG: Yes, our view is that a globally coordinated recession is likely to be avoided. However the next year or so is going to feel pretty downbeat. The impact of higher inflation on household real disposable income will be significant this year. Most economies will experience a decline similar to what might be expected in a recession. Slowing growth is always a worry and concerns over runaway inflation, higher interest rates and war in Ukraine mean risks are biased to the downside.

Having said that, there are also good reasons not to overdo the gloom. Unlike previous deep recessions, there are far fewer imbalances today that require painful adjustments, with both household and corporate balance sheets (in aggregate) in very good health by historical standards. The impact of the various supply-side shocks will eventually fade, and inflation should fall back as they do. There is greater risk of overheating in the US, which will require tighter policy for longer, while the unique set of circumstances in China imply that growth there will also be constrained.

JB: How does all this translate into asset allocation?

MG: The new macroeconomic environment, the monetary policy response to it and the changing views on a range of longer-term structural factors have resulted in an extremely challenging year in financial markets. Global rates markets have re-priced sharply in the face of persistently strong inflation, while risk assets, such as global equities and credit, have performed particularly poorly. Uncertainty about the outlook has increased both implied and realised volatility across all asset classes.

As such, we prefer to have relatively light exposure at this time. We continue to have a preference to be modestly underweight duration, with upside inflation risks outweighing downside recession risks. While there remain significant challenges for equity markets over the coming months, given the sharp fall in equity multiples this year, we prefer a small overweight, apart from in Europe, where the growth risks are more pronounced. We prefer to be neutral in credit, where we think pricing of spreads is roughly fair in terms of recession risk. Finally, we prefer to be modestly long the US dollar against the euro given the relative outlook for the two economies.

JB: We have seen some dramatic shifts within equity sectors, most notably from growth to value during this new interest rate paradigm. How should we be thinking about opportunities within the asset class?

MG: Our positive structural outlook is reflected in our actual allocation and informed by quantitative signals that suggest negative sentiment is already pervasive, but we are tilted towards sectors that are defensive or have already priced in a large chance of recession. High P/E countries and sectors may need to compress more, given the above considerations: tech and growth look to be challenged. Europe has re-priced downwards but remains an underweight.

As real rates and credit spreads rise, together with inflation and wages, margin compression is likely unless sputtering demand picks up again: very strong trailing and projected earnings are vulnerable. We favour firms and sectors with pricing power but, in many cases, there is a struggle to keep up with rising costs and other expenses.

JB: How much higher can interest rates go from here?

MG: Markets are now much closer to fully pricing rate-hiking cycles and, as we have seen in recent price action, investors have just begun to think about the potential cutting cycle that could follow as recession risks grow. However, with central banks focused on inflation, positioning now for any such a turn in policy direction feels premature. Additional fiscal support remains an upside risk to the growth and inflation outlook. Significant uncertainty around economic outcomes and policy reactions mean high volatility within rates is likely to continue.

JB: What's driving the currency markets?

MG: For currencies, risk aversion and rate differentials have been important drivers of dollar strength, particularly against the euro and yen, and we expect them to continue. Although the ECB is now on the cusp of hiking rates, it will not keep pace with the Fed; the yen, Asian currencies and the overvalued CNH (offshore renminbi) are even more vulnerable. The DXY Dollar Index has strengthened considerably since the Global Financial Crisis, but it is unlikely to turn until the rate-hiking cycle has run its course, and the index is still 15 per cent below its 2000-01 peak.

In other G10 countries, faster hikes should provide some protection for countries like Australia, Canada, Norway, Sweden and Switzerland – but euro weakness will weigh on the dollar crosses. For emerging markets, rate hikes have belatedly rebuilt a real rate cushion in many countries. High carry and favourable terms of trade movements have helped Latin America deliver decent returns, and Central and Eastern European currencies (excepting cases like Russia and Turkey) are also being aided by hawkish central banks. At the same time, high inflation equates to low real rates, and G10 rate hikes remain a headwind.