Mid-Year Outlook 2022

Hurricane or storm clouds:
A world in transition
Introduction
Investing through the cycle

Heading into this year, many investors were prepared for a vibrant economic cycle. Now, the outlook is more challenged, with investors asking if there are storm clouds or an economic hurricane on the horizon. The tailwinds from healthy consumers and corporations, as well as innovation remain in place. But the business cycle has progressed at a historically fast pace, while monetary and fiscal policy are no longer adding support.
In our mid-year outlook, we cast our eye on a world in transition and consider what it means for investors, for this business cycle and the next. The transitions we observe are connected to three drivers that may determine the trajectory of the global economy and financial markets in the second half of the year. They are: the end of the era of easy money and the shift to tighter monetary policy; the ongoing ripple effects of Russia’s invasion of Ukraine; and finally, China’s shifting role in the global economy. Will these risks swirl together to form an economic hurricane, or are they merely storm clouds due to pass?

Central banks’—particularly the Federal Reserve’s (Fed’s) campaign against inflation—raise the most pressing issues for investors. U.S. headline inflation, near its multi-decade high, and a tight labor market necessitate tighter monetary policy. But the pandemic’s lingering economic impacts make it difficult to decipher how much tightening is necessary.

The economic impact of Russia’s invasion of Ukraine will likely be most acute in Europe, given the continent’s dependence on Russian energy. Economic momentum is already slowing. The risk of a Russian energy embargo is certainly elevated from pre-war levels.

In China, COVID-19 lockdowns are curtailing consumer activity and the production of goods critical to global supply chains. Policymakers seem committed to Zero-COVID policies that increase risks to the global growth outlook.

Undoubtedly, recession risks have risen. But at this point, a recession over the next 12 months is not our base case.

For their part, markets have already begun to reflect an environment characterized by the end of easy money, slowing economic growth and higher risks.

By “easy money,” we mean the era of historically large amounts of government spending combined with ultra-low interest rates and abundant liquidity support from central banks.

Bond yields have soared, leading to the worst year-to-date performance for sovereign and investment-grade corporate debt on record. Global equity markets have also declined, and the S&P 500 has had one of the worst year-to-date starts on record as well. The most speculative assets—the pandemic-era darlings that thrived when rates were close to zero—are some of the worst performers this year.

Finally, the U.S. dollar is near its strongest level versus major trading partners in decades, which can be disruptive for multinational corporations and for emerging market countries that issue U.S. dollar-denominated debt.

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<tr>
<th>U.S. BOND YIELDS HAVE SOARED TO CYCLE HIGHS</th>
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<tr>
<td>Interest rate, %</td>
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<tr>
<td>10-year yield</td>
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<td>2-year yield</td>
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<td>Fed funds rate</td>
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Source: FactSet. Data as of May 10, 2022.

Year-to-date, multi-asset investors have had little opportunity to hide. Going forward, entry points look much more attractive, and we expect the inverse correlation between stocks and bonds to revive. Put another way, we expect bonds to again serve as portfolio insulators from equity volatility.
Still, we don’t underestimate the challenges of a world—a global economy and global markets—in transition. Neither do we underestimate the potential opportunities going forward. After all, investing through the cycle means investing for the next cycle.

In the following sections, we examine three drivers of economies and markets (the campaign against inflation and the end of easy money, war in Europe and commodity supply shocks, and China’s management of COVID-19 and the resulting global fallout).

We then offer several approaches that may help you stay invested and strengthen your portfolios, for this cycle and the next:

Rely on core fixed income as portfolio ballast. Prioritize balance and quality in equity portfolios. Position for structural change.

First, the three drivers. We take them one by one.
What’s driving economies and markets?
Campaign against inflation and the end of easy money

The Fed’s campaign against inflation has been the dominant driver of global financial markets so far this year. Headline inflation, which touched a 40-year high, coupled with a tight labor market give the Fed justification to aggressively raise policy rates. Over the next 12 months, the market is pricing in the fastest hiking cycle since the 1990s. What’s more, the Fed is embarking on a path to shrink its USD 9 trillion balance sheet to under USD 7 trillion by 2025 (if all goes well). Higher rates and less central bank liquidity—the end of easy money—aim to tighten financial conditions. The question becomes, how much tightening is enough, but not too much?

To start, the headline inflation rate deserves an asterisk, as it is still driven in part by pandemic-era disruptions that are starting to abate. Inventory levels are rising, and inventory-to-sales ratios are recovering just as consumers are shifting from goods to service purchases. We see growing evidence of excess supply in the trucking industry, and global shipping rates are rolling over. Used car prices, which have accounted for one-third of overall consumer price gains since the pandemic started, have also rolled over and begun to fall.

These developments suggest that at least a portion of the inflation we have seen over the last 18 months was related to COVID-19. Thus, even in the absence of Fed policy action, inflation may partially normalize as the pandemic wanes.
The unemployment rate has plunged to 3.6%, clear evidence of a tight labor market. However, the unemployment rate is another statistic that merits a post-pandemic asterisk. Lingering pandemic-era distortions can also be seen in the labor data. Since the start of the year, over 1.2 million Americans have re-entered the work force amid waning concerns about COVID-19. As a result, wage inflation has decelerated to a pace just above the 2018-2019 period.

Importantly, though, over half-a-million Americans still say that COVID-19 worries are keeping them from entering the labor force.

Although the Fed has only just begun its hiking cycle, we are already seeing the desired impact of slowing economic activity. The housing market, the U.S. economy’s most interest-rate-sensitive sector, is slowing. Over the last six months, mortgage rates surged to the highest level since 2009, housing affordability plunged, and mortgage applications slowed.

As we move into the second half of the year, we will start to see more signs that this rate-hiking cycle is accelerating an economic slowdown that was set to happen naturally as the pandemic receded. Our base case is a soft or “soft-ish” landing. But as we’ve noted, recession risks have clearly risen. Raising rates enough, but not too much—it’s a tricky balancing act that has historically eluded central banks.
War in Europe and commodity supply shocks

Russia’s invasion of Ukraine has a tragic cost in human suffering and poses significant challenges to the global economy.

Generally, we don’t think investors should make meaningful changes to investment portfolios based solely on geopolitical events. History shows that underlying economic forces tend to influence markets more than specific geopolitical events. However, when there is a direct link between the event and the global economy, we need to be aware of the potential impacts it could have on investment portfolios.

In the case of Russia’s invasion of Ukraine, the link—energy—is clear. Global benchmarks for crude oil are trading near their highest levels over the last decade, and U.S. retail gasoline prices spiked to record highs this spring. Investors are increasingly worried that volatility in both energy and agricultural commodities could lead to turbulence and destroy demand as consumers forgo other spending to ensure access to necessities.

Europeans import over 20% of their oil and almost 40% of their natural gas from Russia. Not surprisingly, European wholesale energy prices have tripled or quadrupled since the invasion of Ukraine. The European Union recently agreed to a partial ban on Russian oil, aiming to stop 90% of Russian supply imports by year-end. Losing access to Russian natural gas would pose a still greater threat to the European economy. It’s difficult to handicap, but the risk that Europe could face a 1970s-style energy shock has surely risen.

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**EUROPE HAS A GREATER EXPOSURE TO RUSSIAN ENERGY**

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<th>Exposure to Russia, %</th>
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<tr>
<td>Natural gas imports*</td>
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<tr>
<td>Oil imports**</td>
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<tr>
<td>United States</td>
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<td>Europe</td>
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By any measure, Europe’s economy faces a very disruptive supply shock. Many European governments have introduced fiscal schemes to try and shield consumers from the full impact of higher energy costs, but spending growth is set to decline. We estimate that higher energy prices will lead to about a 30% larger hit to overall growth in Europe than in the United States.

An ECB on the move marks a watershed moment for global fixed income investors. After the central bank cut rates into negative territory in 2014, a USD 18 trillion glacier of negative yielding debt amassed in global financial markets. As rates have moved higher this year, that glacier has melted from its peak in 2021 to a mere USD 2.5 trillion. The era of negative yielding debt may be coming to an end, at least for now, and Euro-based investors finally have the opportunity to add yield to portfolios.

This complicates the European Central Bank’s (ECB’s) plan to raise rates for the first time in eight years, but the ECB seems resolute. Raising interest rates while a supply shock is already squeezing real incomes could lead to a sharp downturn.

While the outlook for the broader European economy appears challenged over the near term, equity investors should consider that European stocks are down meaningfully from their highs and trade at a historically wide, 30%, discount to U.S. equities. This suggests that a good degree of risk is already reflected in the price.

Some sectors may provide longer-term opportunities. Specifically, European countries will likely spend much more on defense, and will accelerate investments to secure viable alternatives to Russian energy. Clean energy, cybersecurity, traditional defense and infrastructure could also find consistent support going forward. In addition, we expect a tight balance between demand and supply in most energy, agricultural and industrial commodities, which could support prices.
COVID-19 in China and the global fallout

While the pandemic has become manageable for many, China is dealing with its first meaningful virus surge since the pandemic’s early days. Lockdowns are exacerbating economic weakness in China and pose a risk to global supply chains that are still stressed.

In stark contrast to their peers in other regions, Chinese consumers have been subdued throughout the pandemic era. Spending in all categories but food and tobacco is weaker than it was before the 2020 COVID-19 outbreak. Current lockdowns are easing locally. But limited acquired immunity means that future COVID-19 waves and lockdowns are likely—making it effectively impossible for consumers to drive any kind of above-trend economic growth.
Chinese policymakers have clearly signaled that they want to discourage speculation in the housing and real estate sectors to reduce leverage in the broader economy.

This has led to declines in building sales, new construction activity and home prices for the first time since the 2014–2015 slowdown (which was marked by a currency devaluation and capital flight that spooked global investors).

Exports now drive China’s economy. Booming demand for durable goods in developed economies (especially in the United States) over the last two years led to strong manufacturing and export activity. The problem is that global demand for durable goods is likely to fade, given consumer saturation and the Fed’s tightening cycle.

Global investors would probably welcome increased credit issuance and meaningful policy easing to support growth. However, we aren’t counting on it because we think it is unlikely that the People’s Bank of China would move in such opposition to developed economy central banks.

Recently, Chinese policymakers have allowed the currency to fall relative to the country’s trading partners. This can provide a boost to the domestic economy and introduce another disinflationary impulse to developed economies as Chinese exports become less expensive. But investors could also take currency weakness as a sign of stagnant domestic growth, which is a negative for global corporate earnings.

Continued rolling COVID-19 lockdowns could prolong the supply chain pressures that have contributed to inflation in the United States and Europe. They could also reduce the amount of goods that companies could potentially sell, which could hurt revenues. This presents an important risk to global investors.

All in all, we see an uninspiring outlook for the Chinese economy, with potential disruptive downstream impacts on global growth.

While the onshore Chinese equity markets have already incorporated a slower growth outlook, we have higher conviction in other areas for the balance of the year.

Outside China, other emerging markets are enjoying market gains. Higher commodity prices are improving the external positions of countries such as Brazil, Saudi Arabia and South Africa, while many emerging market central banks are closer to the end of their tightening cycles than the beginning. Emerging market investments could benefit if commodity prices remain elevated and higher interest rates continue to pressure developed world markets with higher valuations.
Preparing portfolios for this cycle and the next
Even as inflation, war, political uncertainty and the ongoing pandemic challenge the outlook, we think balanced portfolios offer compelling potential returns through the end of 2022, especially after the dramatic declines in both stock and bond markets in the first five months of the year.

That said, the end of easy money marks a watershed moment for the COVID-19 business cycle, one characterized by slower economic and corporate earnings growth, and lower inflation globally. Recession risk is elevated. **We think investors can take three steps to prepare goal-aligned portfolios to potentially weather this cycle and next:**

- Rely on core fixed income as a portfolio ballast
- Prioritize balance and quality in equity portfolios
- Position for structural change
Rely on core fixed income as a portfolio ballast

We believe core, investment-grade fixed income is the most efficient way for investors to potentially benefit from slowing growth. For the last two years, bonds have offered neither incremental yield nor useful portfolio protection because interest rates were so low. But now investors are finally getting paid an adequate return and getting portfolio protection should a recession occur.

The risk in holding core fixed income is that rates head materially higher from here. This scenario is certainly possible, as sovereign bond yields tend to overshoot their fundamental ranges during central bank tightening cycles.

Still, for several reasons, we think it’s unlikely. First, as we’ve said, we believe rates are already high enough to engineer the growth slowdown the Fed is looking for. While the hiking cycle has only just begun, the bond market has priced a rapid succession of future hikes, which is already impacting the economy.

Second, most U.S. Treasury yields are trading above the Fed’s estimate of the long-run federal funds rate. This rate has historically served as an anchor for yields. Finally, structural factors of the economy that tend to influence rates (e.g., productivity, population growth and demographics) all argue against a material further rise in interest rates.

Indeed, a risk-reward analysis suggests the benefits of owning core fixed income at current levels outweigh the potential downside. Assuming 10-year Treasury yields rise to 3.5%, core fixed income could return -1% to +1% over the next year.

If a recession does occur, 10-year yields could fall to ~75 basis points, and returns could total 12% to 15%.

What’s more, current yields on core fixed income offer similar expected total returns as equities with less volatility, according to our Long-Term Capital Market Assumptions, our 10-to-15-year risk and return forecasts.

For the last few years, we have been skeptical of core fixed income. But it is time to re-engage with the asset class.

<table>
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<tr>
<th>Potential total return over 12 months</th>
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<tr>
<td>Recession: 0.75% 10-year</td>
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<td>Base case: 2.5% 10-year</td>
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<tr>
<td>U.S. aggregate bonds</td>
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<tr>
<td>U.S. municipal bonds</td>
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<tr>
<td>15%</td>
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<tr>
<td>12%</td>
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<tr>
<td>7%</td>
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<tr>
<td>7%</td>
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<td>1%</td>
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Source: Bloomberg Finance L.P. Data as of May 9, 2022. U.S. Agg represented by the Bloomberg U.S. Agg Index and U.S. Munis TEY used for Muni carry return. Scenario assumptions: 3.0% 10Y-Agg OAS = 65, Muni/10Y UST Ratio = 115%; 2.55%-2.05% 10Y-flat OAS & Muni/Treasury Ratio; Recession—OAS widens to 100, Muni/UST Ratio = 150%.
Prioritize balance and quality in equity portfolios

Turning to equity markets, we expect trend-like earnings growth through the balance of the year. Valuations that are below their 10-year average provide an attractive entry point. But given downside risks, we are prioritizing balance and quality in equity portfolios.

We find these attributes in a variety of sectors and styles: High-quality businesses that provide earnings stability and visibility. A select group of cyclicals that can benefit from continued economic growth. Secular growth companies trading at reasonable prices.

We believe all have a place in equity portfolios. And for this reason, healthcare, industrials and technology are our three favorite equity sectors.

Mature healthcare companies seem particularly compelling. We think they will benefit from a strong demographic tailwind, solid drug development, a history of defensiveness in volatile markets, and the potential for merger and acquisition activity. The healthcare sector also trades at a discount to the broad market given political risks (e.g., new regulation) that we believe are overstated.

We note another attractive characteristic of mature healthcare companies: They tend to have strong balance sheets and consistent earnings growth. Their management teams are reliable capital allocators, and they are usually good partners to investors.

Consistent dividend growth can be an indicator of quality. Companies that are dividend growers also tend to be less expensive than the broader market, have a higher absolute dividend yield, and typically come from defensive sectors such as utilities and consumer staples that are less sensitive to changes in economic growth.

**DIVIDEND GROWTH STOCKS HAVE SEVERAL ATTRACTIVE ATTRIBUTES**

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<tr>
<th>Less expensive</th>
<th>Higher yield</th>
<th>More defensive</th>
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<tr>
<td>P/E ratio</td>
<td>Dividend yield</td>
<td>% in defensive sectors</td>
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<tr>
<td>17x</td>
<td>2.2%</td>
<td>35%</td>
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<tr>
<td>20x</td>
<td>1.5%</td>
<td>27%</td>
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<tr>
<td>20x</td>
<td>2.0%</td>
<td>35%</td>
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In short, in an uncertain macroeconomic environment, quality companies should provide investors with more certainty than their lesser-quality peers.
Position for structural change

The first two approaches we’ve presented—rely on core fixed income as portfolio ballast, prioritize balance and quality in equity portfolios—mainly address the current cycle. Our third approach looks ahead.

As we see it, the next cycle will likely feature reconceived and restructured global supply chains. For more than 30 years, supply chains were increasingly globally integrated. Especially after China joined the World Trade Organization (WTO) in 2001, much of U.S. manufacturing moved offshore. That tide may be turning as geopolitics and the potential for future pandemics prompt business leaders to add resiliency.

In the next cycle, manufacturers may increasingly bring their factories onshore (or nearly onshore) and make them more “autonomous” (more productive and efficient). For investors, this means increased opportunities for robotics and related hardware and software.

The next cycle is likely to also experience meaningful progress (at precisely what speed no one can say) in the energy transition.

The transition will require significant capital investment in both fossil fuels and renewables, along with substantial commodity inputs. This will present a wide range of opportunities for investors, which they can align to their financial (and non-financial) goals and values.

Finally, the new cycle could bring with it a transformed real estate sector. As hybrid home-office, office-home arrangements proliferate post-COVID-19, both the office and single-family housing markets will need to evolve. As more people live and work outside traditional city centers, we see growing need for residential housing investment and the related infrastructure.

As for single family housing, Freddie Mac estimates that supply is short of demand by roughly 3.5 million units, which would take three to five years of constant investment to balance. Certainly, housing is still a cyclical sector. But it is likely to become less cyclical, potentially introducing a credible source of income for investors.

Residential development will likely require traditional infrastructure investment—namely upgrades for roads and bridges in towns and small cities getting new waves of traffic. It will also likely require digital infrastructure to support remote living, such as internet upgrades, cloud computing and information security.

After structural underinvestment, we expect a secular boost to investments in energy, infrastructure, housing and reorganized globalization. Investing through the cycle means investing for the next cycle.
4

Conclusion
Discipline through discomfort

Today’s investing environment may be uncomfortable for investors, but that doesn’t mean it can’t be profitable. In fact, at current levels, the entry point in stocks and bonds looks to be the most compelling in several years. Investors don’t seem to be overpaying for corporate earnings growth, and fixed income provides a viable yield and important protection against a more severe economic downturn.

A BALANCED ALLOCATION YIELD IS THE HIGHEST SINCE 2018
Earning/coupon yield of a 60/40 allocation

Average since the end of 2009 = 4.55%

The risk of a hurricane—a potential Fed policy error and the risks emanating from war in Ukraine, and lockdowns in China—seems well understood by investors. This also probably means that the downside scenarios are at least partially reflected in current prices. It leaves a smaller chance that one of these risks takes markets by surprise and causes more material weakness.

In fact, the bar seems to have been reset lower for what could constitute a positive surprise. If inflation does reach a trend-like pace and the labor market cools, the Fed may not raise rates as far, or as fast, as investors currently expect. Growth, driven by consumers and corporations, has held up admirably through the headwinds. Investors could well uncover opportunity amid the volatility.

We believe long-term investors will be rewarded for enduring the volatility that will likely define markets over the remainder of the year.

But more importantly, in periods of increased volatility and opportunity, you’ll want to revisit your goals-based plan. Your decisions about risk should be intentional, based on the purpose of the “buckets” in your plan. In this way, near-term goals are more insulated from volatility, those meant to fund your highest priority goals in the medium term are positioned for growth and stability, and those with the longest time horizons or purposes beyond your lifetime can be positioned more opportunistically.

As always, we believe designing and revisiting a goals-based plan is the most impactful action you can take to help improve the likelihood of achieving your financial goals.

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<th>Position</th>
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<td>EXECUTIVE SPONSOR</td>
<td>Clay Erwin</td>
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<td>Global Head of Investments</td>
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<td>Sales &amp; Trading</td>
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<td>GLOBAL INVESTMENT STRATEGY GROUP</td>
<td>Elyse Ausenbaugh</td>
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<td>Global Investment Strategist</td>
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<td>Christopher Baggini, CFA</td>
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<td>Global Head of Equity Strategy</td>
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<td>Russell Budnick</td>
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<td>Alex Wolf</td>
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<td>Head of Asia Investment Strategy</td>
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The Bloomberg U.S. Aggregate Bond Index is a benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The Barclays Capital 1-10 Year Municipal Bond Index measures the performance of tax-exempt muni bonds with more than one year and less than 10 years remaining until maturity.

The China Economic Activity Index is a proprietary index constructed by weighted 30-day moving average of daily coal consumption, textile sales, automobile sales, property sales, steel production, as well as congestion delay index, metro passenger volume and air quality index of major cities.

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