Forecast
Market Outlooks

Q3 2022

Forecasts Quarter 3, 2022

Simona Mocuta
Chief Economist
Global Macro and Research
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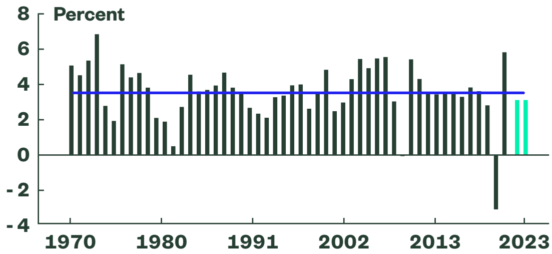
Figure 1
Global Growth Slows as Monetary Tightening Bites

World Real GDP Growth (WEO)
World, Real World GDP State Street Global Advisors Forecast
Long Term Average Growth (3.5%)

Global Economic Outlook



Source: State Street Global Advisors Economics, Oxford Economics, International Monetary Fund. The above forecast is an estimate based on certain assumptions and analysis made by the State Street Global Advisors Economics Team. There is no guarantee that the estimates will be achieved.

- With global monetary tightening in motion amid exceptionally high inflation, the world economy is entering a slowdown. There is a chance of a growth recession or even something worse.
- Signs of normalization in global supply chains have been modest. Firms are now revisiting such arrangements with an eye on shortening and simplifying them.

Simona Mocuta
Chief Economist
Global Macro and Research
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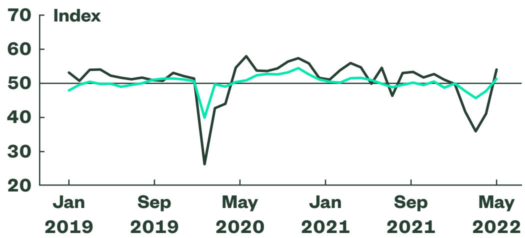
Figure 2
Chinese PMIs Signal Strong Q3 Rebound

Services PMI Business Activity Index
Manufacturing PMI

Emerging Markets Outlook



Source: Macrobond, State Street Global Advisors, IHS Markit, as at 30 June 2022.

- Risks of further lockdowns under China's zero-COVID policy reignited worries in Q2 around global supply chains, growth, and inflation.
- However, June data implied a material increase in activity at the end of the second quarter, indicating a favorable start to the second half of 2022.

Jerry Holly
Senior Portfolio Manager, Investment Solutions Group
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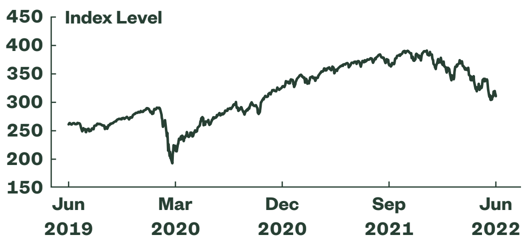
Figure 3
Global Equities Stumble in Difficult Environment

MSCI All-Country World Index, Net, TR, USD

Global Capital Markets



Source: Bloomberg Finance LP, MSCI as of 06/30/2022. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Past performance is not a reliable indicator of future performance.

- The circular risks surrounding inflation, interest rates and economic growth create a difficult backdrop for equity markets, even with the negative returns already witnessed year-to-date.
- The prospects for fixed income are more balanced, but vary dramatically by sector, credit quality and maturity.

Global Economic Outlook

Simona Mocuta
Chief Economist
Global Macro and Policy Research

The world has dramatically changed multiple times over the last three years. From pandemic to the Russia-Ukraine War, the shocks to the global economy have been varied, intense, and difficult to calibrate. Over the past three months, that calibration process has pushed global growth forecasts lower and inflation forecasts higher. The latter caused the global monetary tightening cycle to escalate dramatically. Recession risks have risen.

A Monetary Tightening Tsunami Risks Growth Recession...Or Worse

It is not an exaggeration to say that a veritable monetary tightening tsunami is now in motion. China and Japan are the only major exceptions to the trend, but not nearly enough to counter it. A global slowdown is consequently afoot. Whether it ends up being just a "growth recession" or something worse is yet to be determined. It will depend on how the Russia-Ukraine War plays out, on the extent to which COVID remains a hindrance to economic activity, on the nimbleness of policymakers, and on the timing of all of this. Needless to say, risks are to the downside.

Global growth forecasts have been lowered by five tenths this year and by eight in 2023. It is perhaps the latter change that is even more ominous as it removes the previous expectation of improvement. It also carries more downside risks as the delayed effects of aggressive monetary tightening would be felt more powerfully then, especially across developed economies whose central banks are only now tightening in earnest.

Growth forecast downgrades have been nearly universal. However, Australia and Canada (both commodity exporters with improving terms of trade and resilient domestic economies) were notable exceptions. Somewhat surprisingly, given the limited US exposure to direct Russian trade, the downgrade to US growth was substantial. The main story here is that aggressive monetary policy tightening that's accelerating the slowdown in demand is already underway. To the extent that the US had previously led the global recovery, it now also has less lift from pure "reopening" dynamics. In fact, the latter are one reason why, despite proximity to the war and a considerable hit from higher energy prices, eurozone performance holds up reasonably well. Fiscal support to counter the impact of rising utility costs is another. Germany, however, remains an underperformer; its disproportionate reliance on manufacturing is a liability in a world of sky-high energy prices and persistent supply chain problems. That may change in 2023, however. COVID restrictions in China have forced a downgrade there as well. While we recognize further downside risks there, we also believe that macro support actions will yield results in the second half. To some extent, we see 2022 as China's own "whatever it takes" moment with regard to supporting its economy.

As noted, inflation forecasts have been revised sharply upward, with China the lone exception to the trend. It is impossible to disentangle how much of the inflation surge is due to supply versus demand factors, but it is clear that both play a role. So far, signs of normalization in global supply chains have been frustratingly modest. However, there have been improvements and the coming demand deceleration could spark a noticeable lightening of order backlogs in the coming months. We remain convinced that inflation will decelerate sharply over the next few quarters. We expect to see similar, yet less dramatic, dynamics in wage inflation as economies cool; timing, of course, will vary from country to country. The eurozone and Australia, for instance, are just now in the process of wage acceleration, but wage inflation in the UK and the US appears to have peaked. We are watching the rise in consumers' inflation expectations but are not particularly concerned about de-anchoring.

We continue to ponder questions around the global inflation regime. Following three major shocks (the US-China trade war, COVID, and the Russia-Ukraine War), we believe firms everywhere are revisiting global supply chain arrangements with an eye toward shortening and simplifying them. This transition process will likely be inflationary, yet it is also fairly slow-moving. We suspect that it will also be accompanied by broad technology deployment. The debate around automation — heavily focused on job destruction just a few years ago — may take a more upbeat tone in a world of apparent labor shortages. Technology deployment will be critical to enhancing productivity and perhaps reversing the long-run erosion seen in developed markets for many years. If so, this could put a lid on inflation even as the world moves past peak globalization.

United States: Headwinds Intensified, Resilience Eroded

Back in March, we described the US economy as undergoing a battle between headwinds (from high inflation, rising interest rates, softish external demand) and resilience (from excess savings, strong housing demand, and supply chain normalization). Since then, the headwinds have intensified, and the sources of resilience have eroded.

Our 2022 growth forecast has moved from 4.0% in March to just 2.3% now, an unusually large downgrade. While driven by many factors, at its core it reflects a much faster monetary tightening pace that shifts the economy from the prior path of a gradual deceleration to one of a more abrupt downshift.

Housing can no longer function as a source of strength in a world of 6.0% mortgage interest rates. And consumer spending cannot provide the same support in a world of $5/gallon gasoline prices. At the same time, consumers in the aggregate still sit on substantial amounts of excess savings, and there remains plenty of pent-up demand for automobiles, for example. But the sequential dynamics have changed. Look no further than the personal savings rate, which declined from 8.7% in December to 5.4% in May. The wealth effect, which may not have necessarily buoyed spending per se but has certainly buoyed the consumer mood over the past year, will likely start to act as a drag amid financial market volatility. Household net worth, which had established seven consecutive record highs starting in Q2 2020, retreated during the first quarter of 2022. A much larger pullback seems inevitable in the second quarter.

There is much less momentum left in the inventory-rebuilding cycle, given the surge in inventories during the last few quarters. In the context of softening demand, the shift in these dynamics can become acute, making accurate forecasting extremely difficult. Fixed investment, particularly business fixed investment, has been a bright spot despite weakness in non-residential structures. We expect further gains here, but residential investment seems poised to decline. Even growth in business investment will likely slow quite sharply amid weaker economic growth expectations.

Recession Not A Done Deal

Given this backdrop, the "recession question" has moved to the center stage. We consider it from two perspectives. The first is whether or not the US economy, given the 1.5% contraction in the first quarter and the current -1.5% Atlanta Fed GDPNow estimate for Q2, is already in recession. We do not think it is a done deal, but whether the Q1–Q2 slowdown episode meets the "two consecutive negative quarters of growth" definition is a matter of mathematical semantics. The slowdown itself is real. The much more important question is whether this stumble, driven primarily by inventories and trade (important, yet more peripheral components of GDP) is followed by a more typical business cycle recession down the line (i.e., 2023), where the core forces of consumer spending and investment define the recession, in response to higher borrowing costs. This isn't part of the baseline either, at least not yet.

But we are concerned that aggressive rate hikes could push us onto that scenario path. Indeed, the Fed's prior brisk walk toward policy normalization turned into a veritable sprint with June's 75 basis points (bps) rate hike. In addition to the 150 bps worth of hikes so far, the Federal Open Market Committee has penciled in another 175 bps by year-end, taking the Fed Funds range to 3.25–3.50%. It then expects two additional hikes in 2023 before unwinding those last hikes in 2024. This is a very hawkish profile, one that leaves the policy rate considerably above the estimated 2.5% neutral level for a long time. We still believe that evidence of an intensifying slowdown and progress on inflation would allow the Fed to pause at 3.0% this year and keep the peak rate this cycle at 3.5%. That would help limit the slowdown.

Inflation has continued to surprise to the upside (hence the hawkishness above). Energy prices have a lot to do with this, but there is no question that inflation is both high and broad-based. Headline inflation at 9.1% and core at 5.9% year-over-year (y/y) in June speak for themselves. Still, following an increase of around 8.0% in 2022, we see base effects, the demand slowdown, and supply normalization as a powerful disinflationary combination that allows the 2023 average to come down sharply to 2.2%.

Eurozone: Resilience or Acute Vulnerability?

The eurozone growth forecasts may seem like a puzzle. Given its proximity to the war in Ukraine, given its dependence on Russian energy imports and frantic need to diversify those supply sources, given the refugee influx, and given the surge in utility costs, why isn't the hit to 2022 growth more pronounced? Make no mistake, we lowered the forecast by almost a full percentage point to 2.8% this round, but this is higher than the US growth projection. How come?

There are several reasons for this resilience. One relates to the "reopening" dynamics that are now weak in the US but will play a more supporting near-term role in the eurozone. Another has to do with the fact that European consumers also enjoy a substantial cushion of excess savings; by some metrics, household savings dynamics in the eurozone are even better than in the US. Third, compensatory fiscal measures help cushion some of the blow from higher prices. Fourth, fiscal transfers from the Next Generation EU (NGEU) fund are supportive of investment and growth, especially in select economies. And finally, the European Central Bank's own monetary tightening cycle, while aggressive by its own standards, is not nearly as advanced and nor will it be as dramatic as in the US.

On the other side of the scale is that while the eurozone baseline scenario speaks to resilience, the downside scenario is one of acute vulnerability. This is a scenario not solely of price pain due to high energy prices, but potentially outright shortages and activity shutdowns should supply interruptions occur later this year.

Inflation Spike To See ECB Response

The eurozone inflation spike has proven every bit as vicious as the US one. With headline inflation above 8.5% y/y in June, even our recently-upgraded forecasts may prove too conservative. There are also material risks to the sharp moderation expected in 2023. However, it is important to recall that much more of Europe's inflation is an energy story, and that is not a neverending upward spiral. In fact, perhaps even more so than in the US, there exists an alternative optimistic scenario that can unfold once the acute risk period (mostly the upcoming winter) has passed. The recent sharp pullback in agricultural commodity prices as Ukrainian supplies are accessed is a reminder that prices can swing widely in both directions.

The European Central Bank has maintained a dovish countenance for much of last year. But in recent months, the intensity of the inflation spike has forced a reassessment and, as of the June meeting, a clear guidance that interest rates will move up in July. We see a total of 125 basis points worth of hikes before the year is done, with additional yet more modest increases in 2023.

United Kingdom: Faltering Growth Despite Signs of Resilience

As has been the case almost everywhere, the UK growth outlook has worsened. The 2022 adjustment has been noticeable but not dramatic, with the economy expected to grow 3.8% this year compared with 4.5% back in March. A degree of resilience remains detectable amid generally gloomy consumer sentiment as the reopening dynamics that are aiding continental Europe offer some support here as well. However, elevated inflation is undermining household purchasing power and this will filter through to business confidence and investment. Hence, we more than halved our 2023 growth projection to just 1.0%.

The labor market may be starting to weaken at the margin. The unemployment rate edged up a tenth to 3.8% in the three months to April, though this is still close to historical lows. Vacancies remain at record highs but the expansion rate is moderating. Wage growth may be starting to slow as well. Real earnings are shrinking.

Headline CPI inflation hit 9.1% y/y in May, mainly reflecting high energy and commodity prices. The Bank of England (BoE) sees consumer price inflation exceeding 11.0% in October as higher utility tariffs come into effect. We have made substantial upward revisions to the 2022 and 2023 inflation forecasts, which we have now penciled in at 8.5% and 5.0%, respectively.

Unsurprisingly, the BoE has turned quite hawkish recently, while also acknowledging that risks to growth have increased. In June, a 6–3 majority voted for another 25 basis point rate hike, the fifth time in a row the BoE has raised rates since December. While the BoE's rate hike path seems to be more gradual and less urgent than the Fed, it has promised to act forcefully if inflationary pressure continues to escalate. Even so, the seven rate hikes priced in the market at this point may prove to be a bridge too far.

Japan: Defying Inflation and Interest Rate Trends

Japan's case is a bit different, even among developed markets. Japan's recovery, both in terms of GDP and employment, has lagged peers. Its inflation experience has been far more contained, even though high commodity prices are percolating in the pipeline. But consumer price inflation remains tame and wage inflation negligible. It is in this context that the Bank of Japan (BoJ) has so far remained a bastion of monetary policy dovishness.

Near-term growth prospects remain challenging. We downgraded our 2022 growth projection to 1.2%, while maintaining 2023 growth at 1.8%. We expect trade to be a drag on GDP. However, stable consumer spending could be the silver lining as the COVID recovery unfolds and the country reopens to travelers once again; this could boost spending, especially on services.

The mild inflation uptick witnessed over the last few months should continue and intensify through the rest of the year, leaving average headline CPI inflation at 2.8%. Rising import costs are a key driver as Japan imports 60% of its food and almost all of its fuel.

Given the still-subdued inflation backdrop and challenging growth environment, the BoJ maintained its dovish stance at the June meeting. It is now a lone holdout among developed market central banks, not altering its policy stance even as the global monetary policy tide has shifted violently in a much more hawkish direction. However, the extent of BoJ's intervention in the market to enforce the current policy stance seems unsustainable and so we expect a gradual shift in rhetoric over the latter part of this year. Outright changes to policy targets may not occur until 2023, when the upper limit of the 10-year government bond target could be raised to 0.50%.

Emerging Markets: A Chinese "Whatever It Takes" Moment?

Simona Mocuta
Chief Economist
Global Macro and Policy Research

It is often the case that debates around emerging markets' economic prospects are dominated by views around China. That has certainly been the case over the last several months as severe COVID-driven lockdowns there reignited worries around global supply chains, growth, and inflation.

It has certainly been a very China-focused few months. Even in terms of our own forecast changes, the major changes to EM growth projections this quarter have been driven by the downgrade to China's growth from 5.1% to 4.7%. This remains an upside to the consensus view, and we fully recognize that risks to this number lie to the downside. However, while the second quarter GDP print was very weak by China's standards and has been generally described as a disappointment, it was in fact slightly better than we had anticipated. Moreover, June data implied a material uptick in activity at the end of Q2, offering a favorable launchpad for the third quarter. While the going is undeniably tough, we sense a strong commitment from Chinese policymakers to bring about a turnaround during the second half of the year. One could conceive of the current confluence of events as China's own "whatever it takes" moment. There is no doubt that China's growth potential is shrinking and the ongoing review of global supply chains have negative implications on the world's largest manufacturing hub. But neither of these require a dramatic near-term adjustment. Current pressures on Chinese growth are largely self-imposed; they can also be lifted or compensated for according to policymakers' intentions. And that intent is clear: to revive economic activity during the second half of the year.

Elsewhere across the emerging market universe, our forecast revisions have been fairly muted and mixed rather than universally negative. In Russia, a deep contraction is unfolding but its extent is a little less dire than we previously thought. India's economic performance has also held up somewhat better than anticipated. The biggest question, perhaps, is whether the modest improvement in activity that we have penciled in for 2023 across emerging markets as a whole can be delivered in the context of even weaker growth in advanced economies. China will once again be a key determinant of that.

Global Capital Markets Outlook

Jerry Holly
Senior Portfolio Manager
Investment Solutions Group

A year ago, in this publication, we examined the percolating inflation pressures confronting global economies and capital markets. At the time, consumer inflation in the United States was humming along at 4.9% — propped up by base effects, loose policy and undesirable side effects of economic reopening, such as worker shortages and supply chain disruptions. In our conclusion, we asked whether or not we might be in the midst of another great wave of inflation?

An Overwhelming Wave?

The question was inspired by David Hackett Fischer's seminal work on inflation — *The Great Wave*.[1] And to begin to formulate an answer, we looked to Fischer and his explanation for why the inflation of the 20th century was so misunderstood: "the data are overwhelming, and the event is so close to us that we have trouble thinking of it in historical terms."

The question may be even more pertinent today:

- It's hard to argue against the idea that inflation data, the world over, are overwhelming;
- By definition, these events are close to us as we make markets in real time, day in and day out;
- But does that temporal proximity cloud our judgment with respect to history? And does that even matter for asset allocation over the next 3–6 months?

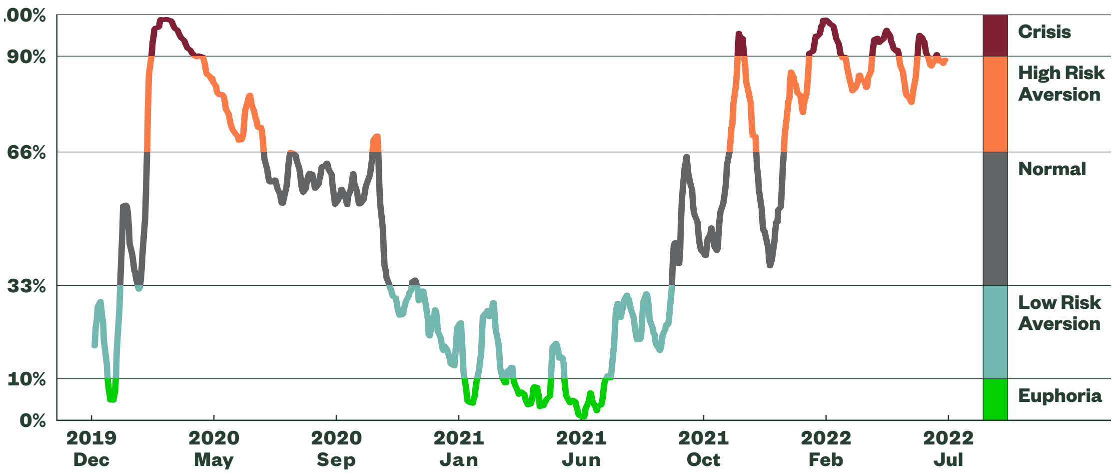
As we wrote in the last edition of Forecasts, complete historical analogues to the current situation are few and far between. To limit our comparative analysis to periods where we witnessed monetary tightening from near-zero levels amid war in Europe, high inflation, an energy crisis and continued fallout from a global pandemic, would be less than productive. But, parallels may still be drawn and will help to bolster the insight provided by our continually refreshed quantitative modeling. While the historical context is useful, we do not want to stray too far from the risks and opportunities of the present (and near future). Regarding today's inflationary ills, readers of the preceding section will be aware that our baseline calls for a deceleration in the coming months and quarters. This offers some hope that markets and policymakers can forge through and avoid some of the nastier scenarios that might unfold. Does that rule out another great wave of inflation altogether? For that it is too soon to tell, but our overall outlook on the markets remains cautious, as the ebb and flow between high prevailing price levels, uncertainty surrounding policy responses, and the threat of a recession continue to keep markets on edge.

Poor Sentiment Shows No Signs of Cresting

Although some of the current inflationary trends started to emerge, in force, during 2021, the overall risk environment couldn't be more different from the past calendar year. The VIX index of implied equity volatility, though nowhere near the levels reached during the COVID crisis, has eclipsed the peak levels witnessed during the economic and market turmoil in late 2018. Bond market volatility, as measured by the MOVE Index, has been far more pronounced — particularly at the front end of the curve. Overall, the MOVE Index has reached levels that rival the peak seen during COVID, and it has spent a good portion of this year at levels in excess of those seen during the taper tantrum in 2013.

The change in tone in the market has been well captured by our internal gauge, the Market Regime Indicator (MRI), as can be seen in Figure 4. For much of 2021, our MRI hovered between the relatively constructive regimes of low risk aversion and (to a lesser degree) euphoria. But we traversed up into a regime of high risk aversion in November of 2021 and have scarcely looked back since then — oscillating primarily between a high risk aversion and crisis regime. Looking back even further, the only reference point where the MRI has shown more persistence across these risk averse regimes was during the Global Financial Crisis in 2007 and 2008. Even with COVID, though the volatility was severe once the crisis regime was breached, markets were able to steadily recover with the assistance of meaningful monetary and fiscal support. Lacking those important crutches today, our assessment of the risk environment has kept a lid on our equity allocations and the MRI continues to point to troubled conditions ahead.

Figure 4
Market Regime Indicator (2019–2022)



Source: State Street Global Advisors, as at 30 June 2022. The data displayed is not indicative of the past or future performance of any State Street Global Advisors product. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The Market Regime Indicator (MRI) is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used, equity implied volatility, currency pairs implied volatility and bond spreads, are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views of those markets. These factors are combined to create a single measure and used to identify one of five risk regimes: Euphoria, Low Risk, Normal, High Risk, and Crisis.

Equities: More than Nominally Cautious

Coming back to the importance of time horizons, one of the challenges that inflationary risks bring to equity market investing is the heightened and persistent volatility that typically accompanies the levitation in price levels. Even if one were firmly convinced that we were only in the beginning innings of an inflationary regime, the right answer is likely not to remain permanently bearish. Take the experience of an equity investor during the period that has come to be known as The Great Inflation.[2] The average annual return of the S&P 500 Index was 7.1%. However, with inflation averaging 6.6% over that period, the real return earned by that same investor was a paltry 0.5% per year. And we could recall even more dire comparisons, such as the greater than 50% loss (in real terms) experienced by the S&P 500 in the middle part of the 1970s. But fear-mongering is not our goal and, over short horizons, nominal return expectations take precedence for asset allocation purposes. In that vein, it is important to recognize that during that 18-year period the S&P 500 advanced by more than 10% in nominal terms in 10 of those years. In real terms, 10% or better returns were achieved in 8 of the 18 years. For a longer view, Figure 5 provides a glimpse of the nominal and real return experience for US equity investors for each of the last seven decades.[3] Though it is early, thus far the 2020s trail only the 1970s and 1980s in terms of highlighting the harmful effects that inflation may have on capital market performance. But if inflation does ebb, and a meaningful recession is avoided, stocks could just as easily recoup much of the early losses printed in the first half of the year.

Figure 5
Average Annual Returns by Decade (1960–2022)

Decade	S&P 500 Nominal Return	S&P 500 Real Return	Difference (Impact of Inflation)
1960s	8.7	6.1	-2.6
1970s	7.5	0.4	-7.1
1980s	18.2	12.5	-5.7
1990s	19.0	15.7	-3.3
2000s	1.2	-1.4	-2.6
2010s	14.2	12.2	-2.0
2020s	9.0	3.6	-5.5

Source: State Street Global Advisors and FactSet. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable. Past performance is not a reliable indicator of future performance.

In our view, the risks to equity markets still outweigh the potential for a meaningful rebound. In addition to the challenging risk environment mentioned above, our equity modeling has also steadily deteriorated since late last year. As one might suspect, the only set of factors that have improved since the turn of the year have been valuation-based. High inflation and slowing manufacturing data have pushed the cycle indicators in a less productive direction. Momentum has clearly worsened, and even quality metrics around operating returns have edged lower. However, the most dramatic area of weakness has been around earnings and sales expectations. This comes before second quarter earnings have begun, where there is widespread concern around how prevailing economic conditions may have impacted sales and margins across the corporate world. Add to that a number of other developments and exogenous risks that continue to cloud the equity outlook. A little bit of deflation might well help the economy, but if it arises to help clear unwieldy inventories, that will not help the bottom line. High wage pressures, strikes and increased unionization efforts are legitimate ongoing concerns. And even for those companies that have managed to perform well during this period, we've seen windfall taxes debated and implemented in some parts of the world. With that as the backdrop, we prefer a relatively defensive stance as it pertains to our overall equity market exposure.

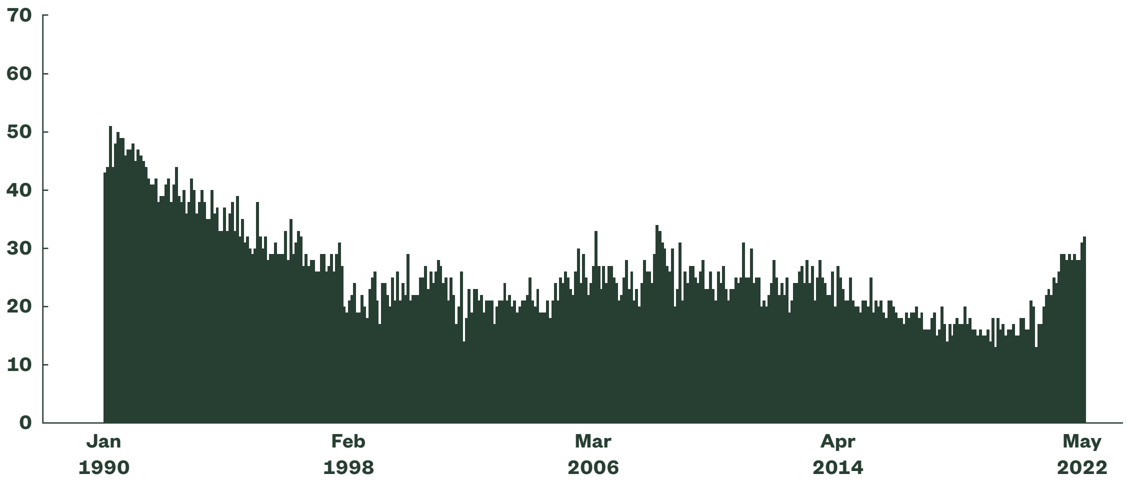
Though we remain cautious on equities overall, we do see some areas of opportunity across equity markets. From a sector perspective, our allocations are barbelled between high beta sectors such as energy and materials and the low beta utilities sector. Energy and materials experienced some significant retracements in June as markets began to take the risk of recession more seriously. And while the hit to short-term momentum is clear, these sectors continue to look attractive based on a variety of valuation and macroeconomic indicators, including earnings before interest, taxes, depreciation, and amortization (EBITDA) multiples and an economic cycle characterized by slowing growth and high inflation. Should that slow growth turn further south, then these sectors could be at risk, but we have not yet seen the data cross that threshold to downsize our allocations. Utilities are typically the lowest beta equity sector and our allocation provides some ballast to the otherwise more cyclical exposures in which we have invested. Utilities fare well in our equity research, based on relatively stable earnings and sales expectations, above-average momentum and improved sentiment from a fund flow perspective.

Bond Markets and Seneca's Central Bankers

To the extent that equity markets are navigating routes that pass between Scylla and Charybdis, the risks to bond markets appear a bit more one-sided. Confronted with inflationary risks and recession, ostensibly the former would continue to deal significant blows to bond valuations while the latter should flatter already-deflated debt prices.

As to the negative scenario whereby inflation persists at elevated levels, this is a risk to which bond markets apparently give relatively short shrift. Implied volatility levels suggest great uncertainty with respect to changes in interest rates, but medium-term inflation expectations are only a hair above 2%, suggesting that market participants are quite comfortable that inflation will moderate either as a result of monetary tightening or economic recession, or both. Consumers are not quite so sanguine. Nearly one-third of those surveyed by the University of Michigan expect inflation to be higher than 5% over the next five years — a level not seen since the oil price spike in early 2008.

Figure 6
University of Michigan Survey of Inflation Expectations
Inflation Next 5 Years: Up by 5% or More



Source: University of Michigan, as of June 2022.

Policymakers don't seem quite so confident on that front. Either that or there has been a newfound popularity in promoting the principles of stoicism as a policy tool. These tactics are most notable when confronted with the risk of a wage-price spiral. In the UK, the Governor of the Bank of England has called for restraint over wage negotiations. In Australia, the proposal offered by the Reserve Bank of Australia was even more prescriptive — a cap on wage growth at 3.5%. In the US, policymakers have been less antagonistic toward workers, but even Treasury Secretary Janet Yellen sought the assistance of Congress in dealing with inflationary pressures. And apart from attempts to proscribe pay raises, we have also witnessed pleas to voluntarily reduce energy consumption from Tokyo to Texas, with acute risks in this regard centered around continental Europe amid the fallout from the Russia-Ukraine War. Policymakers would do well to remember that even short-term price controls can wreak havoc on longer-term expectations, as occurred after the United States imposed a wage and price freeze in 1971.

For our part, a meaningful upward repricing of inflation expectations is not part of our economic or bond market baseline. Where we see greater vulnerability within bond markets is at the short end of the yield curve and in credit assets — both investment grade and high yield. Even with a flat or inverted yield curve, our fixed income research continues to suggest that interest rates at the short end are not where they need to be, despite some of the mixed economic data that has transpired of late. And with higher interest rates translating into a dearer cost of capital for corporates alongside a weakening in economic trends, we have very limited exposure to corporate bonds at this juncture. Long-term government bonds continue to look attractive and, in the event recession risks escalate, should provide some resilience to a multi-asset portfolio.

Still Solid Conditions for Commodities

In the real asset space, we still see a favorable risk/return trade-off in commodity markets. The short-term balances between the bullish supply pressures from the Russia-Ukraine War, China re-emerging from their COVID lockdown, and the bearish demand drag from fears of economic slowdown as central banks adjust their policies to higher inflation continue to fuel short-term volatility. While a fundamental backdrop of tight supply, low inventory, and limited excess capacity in energy sectors remains supportive for prices, rising recession risk and demand destruction from higher commodities prices tempers this outlook to some degree compared with our outlook from earlier in the year. However, contango across commodity curves (where the futures price is higher than the spot price) remains scarce and the June sell-off has not shaken our regime-aware momentum signals. Though risks do appear more balanced at this point relative to other asset classes, the outlook for commodities remains firm.

Thus far, 2022 has delivered an economic and market concoction to which most investors have never been acquainted. High consumer prices, low asset prices and policies that favor Main Street over Wall Street render a cloudy outlook for capital markets. But all this needs to be measured in the context of significant price concessions which are already on offer. With a long enough time horizon, today's investment menu might well be quite appealing. In our view, a sufficient collection of risks remains to favor a defensive stance at the moment.

Sources: Bloomberg, FactSet, J.P. Morgan, Barclays, MSCI, Morgan Stanley and The Economist, as of June 30, 2022.

Endnotes

1 Fischer, David Hackett (1996). *The Great Wave — Price Revolutions and the Rhythm of History*.

2 Here we use a definition of the Great Inflation as the years spanning 1965–1982 per the Federal Reserve. For more information please refer to: The Great Inflation | Federal Reserve History.

3 The 2020s includes calendar year returns for 2020, 2021 and the first half of 2022. The inflation value used for the first half of 2022 was the headline CPI inflation (8.6%) as of the May 2022 Bureau of Labor Statistics News Release.

State Street Global Advisors Forecasts as of 30 June 2022

	2022 (%)	2023 (%)
Real GDP Growth		
Global	3.1	3.1
US	2.3	1.5
Australia	4.0	3.0
Canada	4.1	2.8
Eurozone	2.8	2.1
France	2.9	2.0
Germany	1.7	2.8
Italy	3.0	2.0
UK	3.8	1.0
Japan	1.2	1.8
Brazil	1.5	2.0
China	4.7	5.2
India	7.3	6.0
Mexico	1.8	2.4
South Africa	2.0	2.0
South Korea	2.5	2.4
Taiwan	3.4	2.5
Inflation		
Developed Economies	7.2	2.6
US	7.8	2.2
Australia	5.5	3.2
Canada	5.9	2.8
Eurozone	6.7	2.1
France	5.1	2.0
Germany	6.9	2.2
Italy	6.2	2.1
UK	8.5	5.0
Japan	2.8	1.5
China	2.4	2.3

	30 June 2022 (%)	30 June 2023 (%)
Central Bank Rates		
US (upper bound)	1.75	3.50
Australia	0.85	3.00
Canada	1.50	3.50
Euro	0.00	1.50
UK	1.25	2.50
Japan	-0.10	-0.10
Brazil	13.25	10.00
China	4.35	4.35
India	4.90	5.75
Mexico	7.75	8.50
South Africa	4.75	5.75
South Korea	1.75	2.50
10-Year Bond Yields		
US	2.98	4.05
Australia	3.66	4.78
Canada	3.22	4.21
Germany	1.38	2.24
UK	2.31	3.00
Japan	0.22	0.27
Exchange Rates		
Australian Dollar (A$/$)	0.69	0.74
British Pound (£/$)	1.21	1.30
Canadian Dollar ($/C$)	1.29	1.23
Euro (€/$)	1.05	1.10
Japanese Yen ($/¥)	135.86	115.00
Swiss Franc ($/SFr)	0.96	1.01
Chinese Yuan ($/¥)	6.69	6.60

One-Year Return Forecasts	USD (%)	EUR (%)	GBP (%)	JPY (%)	AUD (%)	CAD (%)
S&P 500	7.1	1.8	0.1	-9.3	-0.5	2.1
Russell 2000	8.0	2.6	0.9	-8.6	0.4	3.0
MSCI EAFE	7.6	2.3	0.5	-8.9	0.0	2.6
MSCI EM	9.0	3.6	1.8	-7.7	1.3	3.9
Barclays Capital Aggregate Bond Index	2.2	-2.9	-4.5	-13.5	-5.0	-2.5
Citigroup World Government Bond Index	0.8	-4.2	-5.8	-14.7	-6.3	-3.9
Goldman Sachs Commodities Index	11.3	5.8	4.0	-5.8	3.4	6.1
Dow Jones US Select REIT Index	5.2	0.0	-1.7	-10.9	-2.2	0.3

State Street Global Advisors Forecasts as of 30 June 2022.
The above estimates based on certain assumptions and analysis made by State Street Global Advisors. There is no guarantee that the estimates will be achieved.

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 30 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $3.48 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as June 30, 2022 and includes approximately $66.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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Marketing communication

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