Insights
Market Outlooks

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Updated 2022 Global Market Outlook: The Risk of a Policy Mistake

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A challenging combination of elevated inflation and softening growth demands vigilance from investors. As central banks accelerate monetary policy normalization, recession risks are rising, requiring a more cautious portfolio positioning.

It is no surprise that, given the geopolitical, policy, and market events of the last few months, State Street Global Advisors' market outlook has evolved from the views we expressed in our 2022 Global Market Outlook (published last December). This update summarizes our most recent thinking, including our current macroeconomic and geopolitical outlooks, as well as market outlooks by asset class.

As we look forward over the rest of this year, we're particularly focused on the risk that the reopening-fueled boom will give way to a bust induced by aggressive tightening. Against this uncertain backdrop, our top-level takeaways for investors include:

- Look for relative value opportunities until uncertainties are resolved
- Consider commodities as a hedge for elevated inflation
- Emphasize quality assets for their earnings resilience

Macroeconomic Outlook: Nervous 2022, Troubling 2023

Simona Mocuta Chief Economist

The global economic environment has become considerably more precarious following Russia's invasion of Ukraine. This powerful stagflationary shock worsens the monetary policy trade-off for nearly every central bank, with the prospect of slower growth colliding with sharply higher inflation. We have trimmed global growth forecasts by a full percentage point to 3.6% and still see risks as skewed to the downside. Meanwhile, upwardly revised inflation forecasts will likely require further boosting.

While the earlier pick-up in inflation was a combination of both supply and demand factors, this latest inflationary impulse is entirely supply-driven. And while central banks are rightly initiating or accelerating rate hikes in a quest to bring monetary policy into better alignment with employment and price indicators, we can't help but feel some nervousness around what may turn out to be excessively aggressive market pricing for rate hikes. We are concerned about a boom-bust scenario brought about by tightening that could prove to be too much, too late; we would prefer a more cautious path. We believe that demand conditions will soften more visibly in coming months and that the inflation inflection that the Russia-Ukraine War has delayed (but not extinguished) will also become evident before long. This may provide an opportunity for rate path recalibration down the line.

It is also important to remember that, despite attempts at growth deceleration, consumers in many developed markets still sit on substantial excess savings. This is the reason we haven't slashed our 2022 European growth forecasts too drastically, for example. We believe 2023 could become more problematic in terms of growth as the savings cushion thins, the inventory cycle turns, and the policy tightening bites deeper.

Geopolitical Outlook: The Third Shock

Elliot Hentov, Ph.D. Head of Policy Research

The Russia-Ukraine War is the third shock to the global economic order in the past half-decade. Following the Trump trade wars and the COVID-19 pandemic, the war further undermines the existing model of global trade and capital integration. The unfettered drive toward globalization came to a halt after 2008, but the rest of the 2020s will see more dramatic reversals away from a global supply chain optimized for efficiency. Instead, numerous sectors beyond technology (2018 trade wars) and healthcare (2020 pandemic) will now be emphasizing reliability. This could imply higher average production costs, but could also imply a higher share of labor income retained in developed economies. For some export-oriented emerging markets, it could also mean a harder path toward economic convergence, as productivity gains would need to rely more on domestic reform than on foreign capital and know-how.

In addition, there are other region-specific effects worth noting. First, the combined energy/agricultural price shock will lead to worsening external balances for large importing emerging and frontier markets. In some cases, this has the potential to be politically destabilizing — Sri Lanka's debt default is likely only the first domino to fall. Geopolitically, the Russia-Ukraine War reduces near-term risks of other conflicts, especially in the Taiwan Strait. In Europe, the boost to defense spending will be meaningful, given low levels of public investment by the big laggards of military spending (Germany and Italy), so the end of the peace dividend could actually be slightly growth-enhancing. Finally, the Russia-Ukraine War and severe US-led financial sanctions have raised doubts about the durability of the US dollar-centric monetary order. In our view, these doubts are misplaced as long as large surplus accumulators do not undergo structural reforms that would reduce their surpluses and their concomitant demand for financial assets in the developed world.

Equities Market Outlook: Relative Value Opportunities Amid Elevated Volatility

Gaurav Mallik Chief Investment Strategist

We retain the bias to equities that we outlined in our 2022 base case. Equity risk premia, which rose across all markets at the beginning of the Russia-Ukraine War, remain above long-term average levels. Our view heading into 2022 was positive on equities due to strong fundamentals; now, with the level of earnings upgrades coming through this season — generally in developed markets — we believe an overweight to equities continues to be justified.

That said, we also believe that caution is warranted, and that investors should look for relative value opportunities across the equity landscape. Our prior view had anticipated that the world would be playing catchup to the US as the economic impacts of business re-openings were realized. We also anticipated a lift from fiscal easing in China. But the Russia-Ukraine War has changed the global investing landscape, directly and indirectly. Elevated volatility in equity markets, influenced in particular by rising commodities prices, will likely remain. We continue to see pressure on European equities as the full impact of energy pricing and other inflationary forces flow through to earnings.

It is also likely that, if the war continues for an extended period of time, risk assets will suffer as a consequence. This means that, even though value is clearly emerging in European equities, we must defer judgment until we see an end in sight to the war. We currently prefer US equities, which are less exposed to the war and its effects.

Lastly, because all risk assets are affected to some extent by both the war and by inflationary forces, we retain a bias to quality assets, with the expectation that quality companies will be able to pass on price increases and maintain their margins more effectively than others.

Fixed Income Market Outlook: Timing the Turn

Matthew Nest, CFA Head of Active Global Fixed Income

It seems clear that the US Federal Reserve is intent on squashing inflation, and market participants are ratcheting up rate-hike expectations accordingly. Yes, fundamentals remain strong with healthy earnings and robust balance sheets for corporate and consumer credit, but central banks around the world are set to drain money from the market at a rapid pace — at a time when growth is already slowing. It seems that the only way the Fed can engineer a soft landing at this point is if inflation eases in short order, allowing the Fed to ease off the break. While inflation likely peaked in March of this year, it remains unclear whether it will slow enough to give the Fed the window it needs. The 2 year/10 year curve briefly inverted in April but has since steepened to positive territory, and the 3 month/10 year curve remains very steep. At the same time, geopolitical issues remain front and center and have been adding to negative sentiment. So is this a growth scare or are we looking at a recession in the not-too-distant future? And what does that imply for portfolio positioning?

Our scenario analysis points to an increased probability of the recession scenario, relative to the soft landing scenario, but timing, depth, and duration remain open questions. Value has been building in the term structure of interest rates, but not enough to underwrite the negative momentum and inflationary concerns for the time being. And while credit spreads have widened to reflect some of the issues above, they don't offer deep value at this point — in a recessionary scenario, they would continue to widen. As such, we remain conservative on both fronts and are focused on timing the turn.

Commodities Market Outlook: Structural Bull Market Will Continue to Lead to Elevated Prices

Michael Narkiewicz Senior Portfolio Manager, Investment Solutions Group
Robert Guiliano Senior Portfolio Manager, Investment Solutions Group

Commodities are experiencing the strongest rally in more than 30 years, with broad-based gains seen across the energy, metals, and agriculture sectors. We anticipate that raw material prices will remain elevated throughout the year, as the structural bull market is supported by limited spare capacity and supply-demand imbalances that are proving difficult to alleviate.

Since the end of 2020, the Organization of the Petroleum Exporting Countries and its allies (OPEC+) have pushed prices higher by reducing global crude oil inventories by over 700 million barrels, i.e., putting total stocks at their lowest level since 2014. The Russia-Ukraine War has further highlighted Russia's global energy influence and the reality that their exports of crude oil and natural gas cannot be easily replaced (due to limited spare capacity). Europe receives approximately one-third of its natural gas supplies from Russia, and disruptions to an already tight market have set the stage for prices to continue to rise because alternative energy sources are not readily available.

Industrial metal inventories remain at tight levels, especially copper and aluminum, where balances have been tightening at a pace reflective of robust global demand and Chinese industrial activity (despite recent COVID disruptions). As sanctions against Russia were implemented, global manufacturers have halted engagement with Russia as a trade partner, thus creating a further upside for metals due to supply disruptions. Precious metals have more of a measured outlook, as gold has been supported as an inflation hedge and a safe-haven asset, but higher real yields may provide a headwind.

Surging global commodity demand coming out of the lows of the pandemic — combined with adverse weather-related impacts — have resulted in a significant rise in agricultural prices. Both Russia and Ukraine play a major role in supplying the world with wheat, corn, and barley, along with inputs to fertilizers used by farmers globally. All should see higher prices in the months to come.

At the macro level, the current environment remains favorable for commodities, which have historically performed well during periods of higher inflation. In past inflationary periods, commodities have provided superior protection from rising costs and have offered diversification benefits to traditional stocks and bonds.

With prices across the commodities complex at elevated levels, concerns about a hawkish Fed and about demand destruction are causing investors to wonder if the rally can continue. We acknowledge there may be bumps in the road. Geopolitical risk will contribute to heightened volatility, particularly for those commodities for which Russia and Ukraine have significant global export dependency. However, we expect prices to stay elevated throughout 2022 as the structural bull market within commodities remains intact.

Emerging Markets Outlook: Finding Potential Opportunity Amid Mounting Challenges

Laura Ostrander Emerging Markets Equity Portfolio Manager and Macro Strategist
Aaron R Hurd, FRM Senior Portfolio Manager, Currency

In the aftermath of Russia's invasion of Ukraine, many of the same challenges to emerging markets (EM) remain. External (global) challenges include tighter liquidity, a narrowing growth differential compared with developed markets (DM), moderating economic growth, and geopolitics. Internal (domestic) challenges include slowing growth, rising inflation, large fiscal deficits, rising debt levels, and this year's election/political cycle (especially in Latin America). Relatively new challenges include a changed geopolitical landscape (Russia-Ukraine War, China/Taiwan risk, US/China tension), prolonged pandemic-related supply disruptions, China's "Zero-COVID" policy, and higher commodity prices (especially food and fuel). Add in some uncertainty from China's regulatory environment and weak property market, and this set of old and new challenges points to continued deterioration in EM growth prospects.

Balancing that view, however, is the reality that many EM countries are actually in a decent position to weather a world of tighter liquidity and increased uncertainty. Many EM central banks have had a running start in terms of monetary policy tightening, many EM countries have improving current account balances, and many EM currencies are historically undervalued. Foreign positioning in many EM local markets is not overextended. And commodity-exporting countries are benefiting from higher prices, improved terms of trade, and economic growth.

EM equity valuations do appear to be pricing in some risk. EM equities are currently trading at a greater than 30% discount to DM equities. The MSCI EM forward P/E of 11.3 is spot on its long-term average. The spread on the JPM EMBI GD external debt index, currently 435bps, is more than 85bps higher than its 10-year average. The yield on the JPM GBI-EM GD, currently 6.68%, is almost 80bps higher than its 10-year average. Emerging market currencies also remain at attractive levels relative to historical levels and to estimates of fair value.

China

China's "Zero-COVID" policy and lockdown strategy remain a risk to the country's economic growth. China's property sector also remains a risk and will continue to be a drag on economic growth in the near term, making the "about 5.5%" GDP growth target for 2022 difficult to reach. Recognizing this, at its April 29 quarterly economic meeting, China's Politburo vowed to step up stimulus to support the "growth and social" target for 2022 (set in December 2021) and pledged to "go all out to expand domestic demand." They also vowed to strengthen infrastructure FAI[1] and quelled market fears on the regulatory tightening front. Growth concerns in China typically lead to a pause in new regulatory tightening (or to easing), so it appears that peak regulatory tightening is done for now.

The PBoC cut the RRR rate by 25bps to 11.25% on April 25, anticipating the likely economic growth hit from the March Omicron outbreak and the lockdowns that remain in place. The rate cut is a welcome, though measured, policy easing step. The Politburo economic meeting signals a clear stepping up of targeted policy stimulus and should, in the near to medium term, cause China's credit impulse (which bottomed on the country's earlier pivot toward gradual policy easing) to move decisively higher. The upturn in credit creation is positive for both industrial commodities and EM equities.

Valuations on Chinese equities have moved lower despite a steady and broadening earnings base — the current 12-month forward P/E is 9.7 (versus 12.0 in April of 2019). Earnings growth for China is expected to rise by over 15% in 2022 and by another 15% in 2023 — this compares favorably with expectations for MSCI EM (10% for both 2022 and 2023), to overall DM (10% for 2022 and 8% for 2023), to the US (just under 10% for both years), and to Europe (10% for 2022 and 5% for 2023).

Stability — political, economic, and social — is key for China this year as President Xi looks to secure a third five-year term at the National Party Congress this fall. China's Politburo did reiterate that "housing is for living, not for speculation" at its April 29 meeting, although they did give local government more space to ease property policies. We continue to expect gradual and targeted easing of policies to prevent further downside to this sector. Despite this easing, some property companies will likely be allowed to fail, while those deemed systemically important will likely be bailed out by the government.

Endnote

1 Fixed-asset investment.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- 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 $4.02 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of March 31, 2022 and includes approximately $73.35 billion USD 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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