The Rocky Road to Normal: A 2022 Mid-Year Review

The U.S. economic outlook

After more than two years of the pandemic, most Americans are now returning to normal activities, providing a significant boost to aggregate demand in the short run. Conversely, demand is being reduced by a fast-falling U.S. federal budget deficit. On balance, we expect growth will drift lower in 2H 2022 as demand is hit by fiscal drag, a high U.S. dollar, higher mortgage rates and lower consumer confidence. This does not imply a collapse in demand, given pent-up demand for housing, cars and travel and leisure services. The red-hot American job market is also a sign of prevailing economic resilience.

On inflation, some transitory forces, such as high energy prices, the semiconductor shortage and government aid, should start to normalize and bring down the headline numbers in the months ahead. However, the effects of higher wages, higher housing costs due to the lagged impact of rising home prices and higher inflation expectations would imply a slow grind lower and stay above the Federal Reserve's (Fed) policy target.

In the near term, we expect the Fed to remain focused on controlling inflation and driving policy rates towards 3% by end-2022. In 2023, we expect some slowdown in the pace of tightening, raising rates by 0.25% only in every second meeting, although continuing the gradual reduction of its balance sheet.

The economic outlook of China & Asia

The lockdowns in China now mean that economic contraction in 2Q 2022 is likely and supply chains remain stressed. We see the following conditions as necessary for a more sustainable growth outlook:

1. The implementation of a pandemic strategy that permits a sustainable peak in lockdowns. This involves accelerating vaccinations, tracking and testing, and adjusting the work environment to help contain the outbreak.

2. Revive momentum with large-scale policy stimulus. The stimulus package announced in late May had a broad remit covering fiscal, monetary and energy policies, as well as improving supply chains.

3. Confirmation of the regulatory cycle has moved from "introduction" to "status quo."

Asian economies should enjoy additional growth momentum from their economic reopening to both domestic demand and the tourism sector. Central banks across Asia are likely to lag the Fed in its aggressive policy path, but will gradually raise interest rates. The lower starting point for inflation in many Asian markets suggests less urgency, while better current account positions suggest that countries may not need to act to defend their currencies.

Fixed income

Most of the detrimental impact on fixed income is likely behind us assuming that the full repricing of this year's rate hikes are fully configured into bond yields. Importantly, given the Fed's transparency, it is likely rate volatility will fall in 2H 2022 and into 2023. The move higher in rates and credit spreads has led to some of the most attractive yields/valuations seen in recent years.

We anticipate the nominal U.S. 10-year Treasury yield will end the year between 3.00%-3.25%, suggesting a modest move higher in long rates as the Fed reduces its balance sheet and inflation concerns linger. This rise is still relatively mild compared with the past 12 months.

Equities

With the Fed set to continue normalizing monetary policy over the coming months, equity market volatility will likely persist and valuations will likely remain under pressure, leaving corporate profits as the primary driver of returns. Although 1Q 2022 earnings were better than expected and consensus earnings estimates have steadily risen so far this year, the outlook for profits rests on the ability of companies to defend margins. We prefer large caps but believe there are opportunities across both value and growth.

Asia's performance so far has been weighed down by valuation de-rating and margin underperformance. At a >30% discount, Asia now trades at a significant discount compared to the U.S. The improvement in COVID-19 development, coupled with gradual re-opening of more Asian economies, should provide a significant boost to domestic services consumption. Looking ahead, earnings upgrade should be concentrated in cyclical sectors that serve their domestic markets. Asian economies are less vulnerable compared to 2013-2014, and we continue to expect Asian central banks to hike in an unhurried manner.

For Chinese equities to sustainably recover from their recent correction, investors need to regain conviction and confidence about the China markets. Hopefully, these will be restored when more detailed policy implementation plans, as well as a clear roadmap for lifting pandemic containment, are laid out. With Chinese equities trading at discounted levels not seen since 2018, investors will want to be positioned to capitalize on the sentiment-driven pick up. We remain constructive on sectors with policy tailwinds, such as renewable energy and decarbonization, as well as consumer goods and services that benefit from stronger income growth for the lower income group.

Alternatives

Given the breakdown in traditional negative stock-bond correlation, alternative assets, whether infrastructure, real assets or hedge funds, can still provide valuable attributes such as income generation and diversification benefits.

Core real assets are in focus, as real estate, infrastructure, timberland and transportation assets have all historically provided investors with both inflation mitigation and income. While there is some cooling in the private equities space, private credit, direct lending and mezzanine debt strategies remain attractive. Hedge fund and macro strategies provide some additional anchor points during elevated market volatility in the public market.

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