MACQUARIE

Investment Strategy Update #128

Tug-o-war: Are markets too optimistic or are economists too pessimistic?

- Global recession remains the base case for Macquarie's macroeconomics team. However, the start of 2023 has seen a growing divergence between what economists are forecasting and what financial markets are implying about the growth outlook.

- If recession is avoided, then markets are probably right to think the worst is behind us, but we are still in for a bumpy few months as growth momentum weakens. On the other hand, if recession unfolds, then markets are overly optimistic and the reality of slowing growth will need to be priced in at some stage in the coming months.

- We don't see anything wrong with markets trading more optimistically due to reduced downside growth risks. China is now an upside rather than downside risk driver, supply chain disruptions and elevated energy prices have normalized and the decline in inflation is raising the likelihood that the Fed is getting close to peak rates (and in turn reducing the likelihood they need to overtighten).

- However, regardless of near-term improvements, global growth momentum is set to weaken further as the damage from rising policy rates finally hits resilient labour markets and slows aggregate demand. It is yet to be seen whether downside is shallow enough for markets to permanently look through this growth weakness or whether it will drive another leg down in risk assets.

- In the near term, we think the outlook for markets will still be determined by the prospect of recession and/or what the Fed does. If recession can be avoided, then markets are right to focus on positive developments and look through growth weakness. But if recession unfolds, then markets are not priced for this outcome and will trade lower.

- We have to wait to see how the economic outlook transpires but at this stage recession remains Macquarie's central case although the risks of a hard landing are declining and that does remove some downside risk for markets.

- It is possible that we simply oscillate between optimism and pessimism over coming weeks and months until there is clear evidence one way or the other. But a slowdown should be short and shallow, and investors should be leaning into risk assets over the coming months regardless of the current debate on the size of the economic downturn. We think that the focus should remain on adding to risk assets at cheaper valuation rather than becoming overly fixated on whether economists are too pessimistic.

A positive start to 2023

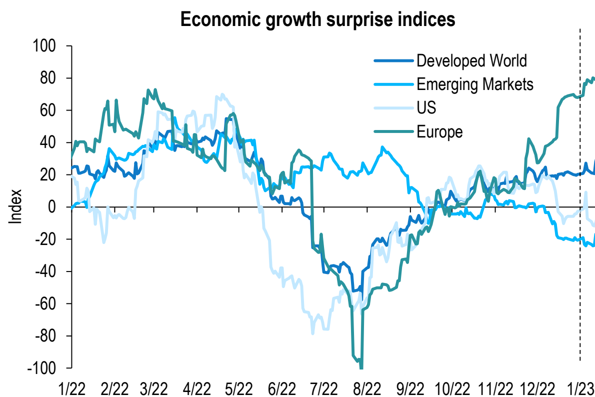
Over the past few months, a lot has been written about the deteriorating momentum of global economic growth. In simple terms, inflationary pressures, tight financial conditions, elevated energy prices and (some) supply chain disruptions have weighed on the performance of many economies and will continue to do so as we move into the new year.

Macquarie's base case is that economic growth momentum is set to deteriorate, as the transmission of tighter financial conditions weakens resilient labour markets and dents aggregate demand. However, some recent data developments may begin to shift expectations around the potential magnitude and depth of a global recession from hard landing to less severe.

Specifically, a persistent decline in headline US inflation rates (the seventh consecutive monthly decline), better-than-expected manufacturing data (especially in Europe), falling energy prices and China's swift reopening are providing hope for an improved growth trajectory and that peak growth fears are now behind us.

Europe in particular has performed better than anticipated, with several economies including Germany, France and Italy experiencing less severe declines in manufacturing activity than initially projected. Additionally, higher than forecasted temperatures in the Northern Hemisphere have subdued fears of an extremely cold winter that would have caused energy shortages, in turn helping ease gas prices.

Economic growth in Europe has surprised to the upside



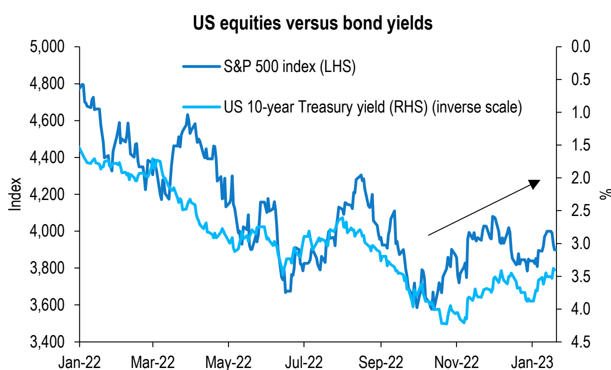
Source: Factset, MWM Research, January 2023

Positives are not enough to change Macquarie's base case…yet

A global recession is still Macquarie's base case with the US, UK and Europe still expected to see modest contractions in output this year. However, a growing divergence between economist forecasts and the recent performance of financial markets suggests the previously unified consensus on the growth outlook may be shifting.

Risk assets, (equities and credit) have both reacted favourably to recent positive data developments, particularly the continued decline in US inflation which is raising the prospect that the Fed may be closer to the end of its monetary tightening cycle than thought just a few weeks ago. As a result of shifting inflation and policy expectations, bond yields have also been falling. This has allowed many growth stocks (which were 2022 loss leaders) to rebound sharply including commodities which had been weighed down by China's zero-COVID push.

Equities have rallied as yields have fallen



Source: Factset, MWM Research, January 2023

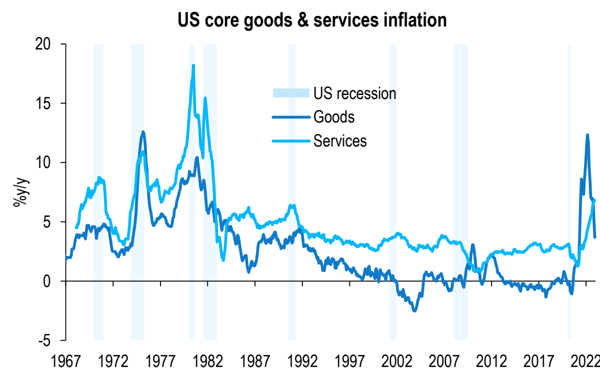
At this stage, we think it is premature to look through the pending growth slowdown and towards more supportive monetary policy conditions. Investment views need to be dynamic and adjust to a change in circumstances and data developments have been positive. But they have not been consistent enough or strong enough to alter Macquarie's base case economic outlook.

Instead, we think they are working to remove the bear case of a hard-landing or a more protracted downturn rather than shifting to a soft-landing scenario. Our economics team make the following key points around the US recession outlook (which is key to the global growth view and the direction of Fed policy):

1. At this time last year, US headline CPI inflation breached 7% for the first time since the early 1980s. Caught flat footed, the Fed undertook a pivot for the ages, increasing the Fed Funds Rate target by a dramatic 425 basis points in the nine months to December.

2. Encouragingly, the Fed's aggressive actions look to be working, with commodity and goods prices falling. However, while both headline and goods inflation peaked in June, the core services component of the CPI is yet to moderate.

Looking for an improvement in services inflation



Source: Factset, MWM Research, January 2023

3. With the economy already on the brink of recession (the composite ISM new orders fell to 45 in the month of December, a level that has only previously occurred during a downturn), we expect services inflation to begin to gradually moderate in coming months.

4. However, it is likely that the Fed will want to see significant further wage disinflation before it can be confident that inflation will return to target. We expect the Fed to pause soon. However, with wage growth still too high, they are likely to keep rates well above their 2.5% neutral estimate until unemployment is increasing, and wage growth is clearly on track to slow into the 3% range.

A further extended period of tight policy, in conjunction with current weakness, suggests the most forecast recession in history remains likely. Indeed, taken literally, the recent ISM

suggests that it may be imminent according to our Macquarie's macroeconomic team.

GDP growth forecasts: Recession still forecast in 2023

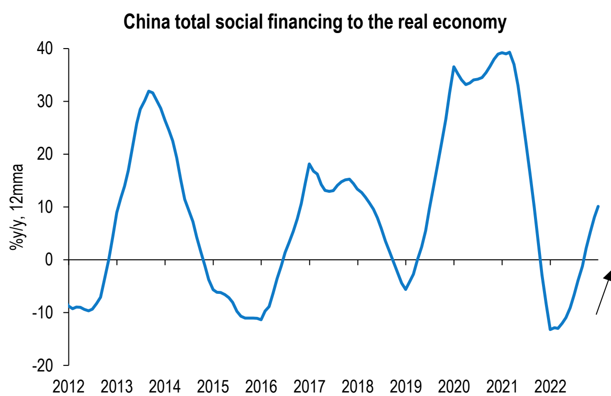
	GDP growth forecast		
	2022	2023	2024
US	2.0	-0.2	0.7
China	3.1	5.5	5.0
Eurozone	3.2	-0.7	-0.1
Japan	1.4	1.1	0.6
UK	4.4	-1.2	-0.2
Canada	3.5	-1.4	0.0
Australia	3.9	1.6	1.5
New Zealand	2.4	1.0	0.2
Global (MER)	2.9	1.5	1.7
Global (PPP)	3.1	1.8	1.8

Source: Macquarie Macro Strategy, MWM Research, January 2023

China now adding to upside risks

That said, the most encouraging development for the global economy has been seen within China. A swift cessation of pandemic restrictions alongside boosting credit growth and property sector supports is helping to remove downside risks to the global growth outlook.

China credit growth is rising sharply



Source: People's Bank of China, MWM Research, January 2023

… But too little too late

The recent smattering of positive data developments and China's rapid reopening have rightly underpinned the rally in risk assets and bonds. But we do not think they will be sufficient to reverse the economic downturn that is in various stages across the globe.

However, investors should be encouraged by these developments because they are helping to remove some of the downside growth risks and they could quickly banish fears of a hard landing which would have driven a much more prolonged bear market and defensive portfolio allocation. To sum this up:

- Recession remains Macquarie's base case and equities are not priced for this outcome, even if it proves to be shallower and/or shorter.
- Growth momentum is not about to turn up despite the smattering of positive data and neither is the Fed on the cusp of communicating that a policy pivot is imminent.
- We think markets are likely to bottom well before 2H and consensus might be surprised on the timing and size of the recovery, but before then, the data will be mixed.
- We think being a little sceptical of the recent rally is prudent. We think early year strength will fade if Macquarie's economic call is correct, but that the downside might not be as large as feared in late 2022.
- We would be leaning into risk assets over the coming months and in particular adding to equity allocations on weakness and for portfolios which are highly defensive or sitting on excess cash.

Macquarie WM Investment Strategy Team

The report was finalised on 23 January 2023.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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