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# 2022 Global Macroeconomic Outlook: Mid-Year Update

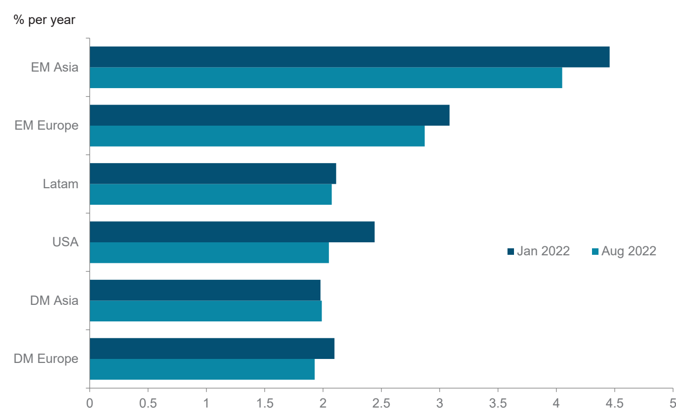

## Summary

*In this macro letter, we analyze current economic trends and provide an update on the market views shared earlier this year in our whitepaper "Geographic Diversification in Private Equity Markets." The fast acceleration of inflation through H1 2022 and the broadening of inflationary pressures have led most central banks to reverse course on their ultra-accommodative policy stance. Broader concerns about stagflation, therefore, don't seem likely. However, in this cycle, much will also hinge on how markets react to quantitative tightening. While our analysis suggests that much of the Fed's remaining rate hikes have already been priced-in by markets, the same conclusion does not hold for its quantitative tightening program. Whether a long-lasting recession can be avoided will depend on how persistent U.S. inflation turns out to be in face of planned tightening for 2022, but we still expect the U.S. economy to be sufficiently resilient to withstand currently projected rate hikes.*


## Macroeconomic Update

Since the beginning of the year, the global economy has been hit by multiple shocks, including the Russian invasion of Ukraine and more supply chain dislocation from Chinese lockdowns, which have led us to upgrade our view on inflation and downgrade our growth forecasts. We now expect gross domestic product (GDP) to grow by 2.8% in 2022, down from the 3.8% predicted at the beginning of the year. These overlapping crises have prompted an upward revision to our year-end Brent oil price forecast to $103/pb, lifting our 2022 global consumer price index (CPI) inflation forecast to an annual average of 7.7%. However, we still expect inflation to peak in the second half of 2022 before slowing gradually thereafter. We forecast food and energy prices to remain high next year, but annual inflation rates for these commodities are expected to fall sharply, which will help trigger weaker-than-consensus headline inflation in 2023.

*Figure 1 – World: GDP Growth by Region 2021-2026*




Source: Oxford Economics - Regions weighted by MSCI index weights

Broader concerns about stagflation therefore don't seem likely. If there is a recession, we expect it to be short-lived with limited impact on earnings and asset prices. The greater risk for returns is persistently higher inflation, but we think the risk of an "accidental" de-anchoring of inflation will be influenced by structural disinflationary forces. During the 2010s, a combination of persistently deficient demand and several forces limiting the pass-through of inflation pressures meant central banks seemed to be powerless to prevent sustained inflation undershoots. Although these factors have waned somewhat during the pandemic, excess global savings and weaker pass-through from wages to inflation remain, limiting the risk that inflation stays sustainably high.

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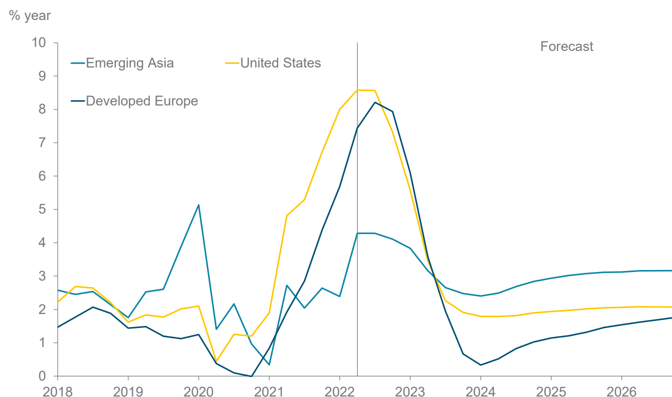
For high inflation to persist, policymakers would need to fail to tighten policy sufficiently or have their policy remits adjusted. But there is little sign of this risk materializing as policymakers have begun to tighten policy at a much faster pace than expected at the start of the year. The Federal Open Market Committee (FOMC) is set to hike interest rates further over the course of this year and next and seems ready to take a restrictive stance if that is what it takes to stem inflation expectations and ingrained higher wage inflation. As a result, inflation rhetoric is cooling while nascent signs of economic weakness are stoking recession fears. Layoffs are creeping up and job offers are being rescinded. Consumer spending and income growth have disappointed, and consumer confidence has plunged in recent months. As a result of the more downbeat macroeconomic picture, we have downgraded our growth outlook for the U.S. since the beginning of the year, from 4% in 2022 and 2.5% in 2023 to 1.7% and just under 1%, respectively.

*Figure 2 – World: Consumer Price Inflation*




Source: Oxford Economics - Regions weighted by MSCI index weights

Growth in developed Europe in 2021–2026 is also set to moderate to just 1.9% per year, as the European Central Bank (ECB) has raised rates for the first time in a decade with additional rate hikes expected over the course of this year and the next. The risks of at least a mild recession are rising fast as policymakers are making commitments to restore price stability. The ECB also faces additional pressure due to fragmentation risk, further clouding the outlook. Even before the first rate hike of the cycle, peripheral government bond spreads widened, demonstrating the possible requirement for further policy to ensure the cohesion of the bloc. More broadly, this underscores that tightening monetary policy to counter largely imported, supply-driven inflation at a time of great uncertainty over the growth and inflation outlooks comes with clear risks to growth and financial stability.

Emerging Asia and emerging Europe remain the two fastest growing regions but face significant downside risks. Emerging Asia, which we forecast to see 4% growth per year through 2021–2026, sees potential headwinds due to China's lockdown policies. The Shanghai lockdown earlier this year and resulting logistics delays in some regions have severely affected supply chains and retail sales were hit even harder by mobility restrictions and Covid caution by households. Further Covid outbreaks will affect activity from time to time, even though we expect them to be less disruptive than the Shanghai lockdown. Meanwhile, emerging Europe faces meaningful potential downside risks due to proximity to Russia's invasion of Ukraine, and the knock-on effects of sanctions and conflict for the region's fuel and food supplies. A significant extension or expansion of the conflict would lead to additional reduction in expected growth for the region.

## Public Markets

After the sharp market correction in the first half of 2022, we expect equities to bounce back as valuations have room to improve and the discount rate shock proves fleeting. This is in line with historical experience: once a 20% fall has been exceeded, equities have fallen a further 14% on average. The most extreme further losses coincide with economic recession. However, losses are usually recovered quickly. Twelve-month returns have averaged over 13% for those investors that bought immediately after a 20% decline, with the average rebound in recession periods slightly higher over that time horizon. Furthermore, with inflation close to its expected peak, there

*Figure 3 – S&P Returns Post a 20% Decline*

Note: analysis covers 14 bear markets from 1940 to date. Returns calculated from closing price on day 20% level was breached.

Source: Oxford Economics

is potential for the Fed to become less aggressive in its approach. Combined with our expectation that treasury yields should not rise much further than what has already been priced-in, this should support equities—if a recession can be avoided.

However, in this cycle, much will also hinge on how markets react to quantitative tightening. Our analysis suggests that although U.S. stock markets have now priced in all the announced Fed tightening for this year, only a third of the expected balance sheet reduction in 2023 is reflected in current prices. Moreover, there are trillions more to be shed by the Fed and its counterparts before central bank balance sheets reach anything resembling the old normal. Just as extreme excess liquidity helped push valuations up strongly during the pandemic recovery, so its withdrawal could prove a significant headwind for markets.

Beyond lower valuations, we also expect profit margins across advanced economies, and in the U.S., to fall back from their latest peaks. However, we believe that this contraction will be offset by top-line growth as global activity remains relatively robust. Stronger earnings per share (EPS) growth is likely to support higher returns for emerging markets, particularly in Asia, while most European markets benefit from relatively cheap starting valuations and higher dividend yields. We also continue to see a weaker USD over the next few years, although we may have to wait a little longer for the peak, until we see reduced uncertainty regarding the macro-outlook and the steady-state Fed funds rate.

## Private Markets

In our paper, *Geographic Diversification in Private Equity Markets*, released earlier this year, we described Ben's portfolio management framework, our risk-adjusted forecasting methodology and private equity allocation views. In this section we briefly review our updated optimal geographic allocations and their risk/reward rationale (Fig 4).

***Figure 4 – Optimal Allocations (Bullish, Bearish, Neutral)***

| Private Equity | Jan-22 | Update | Venture Capital | Jan-22 | Update |
|---|---|---|---|---|---|
| North America | +1 | neutral | North America | -1 | neutral |
| Latin America | -1 | neutral | Latin America | -1 | neutral |
| Europe, Developed | -1 | -1 | Europe, Developed | -1 | -1 |
| Europe, Emerging | -1 | -1 | Europe, Emerging | +1 | -1 |
| Asia, Developed | +1 | +1 | Asia, Developed | +1 | +1 |
| Asia, Emerging | +1 | +1 | Asia, Emerging | +1 | +1 |

Source: Using Ben's proprietary portfolio construction and risk environment and MSCI Barra analytics, Preqin and Burgiss market data.

While we still forecast relatively good risk/reward tradeoffs to be broadly available in U.S. private markets, we recently updated our North American allocation tilt from "bullish" to "neutral" due to increased inflation risks, the potential impact of higher rates on leveraged buyouts and lower expected long-term economic growth relative to China. Our private equity allocation across Europe remains "bearish" as our analysis suggests slightly lower expected growth and a higher investment risk level related to increased European fragmentation as well as the war in Ukraine. As previously discussed, we remain broadly "bullish" on Asian markets, as we see good long-term growth potential in China with mostly short-term driven risks associated with additional Chinese lockdowns. Additionally, low inflation risks in developed Asia, especially in Japan, make for good risk-adjusted expected performance despite a slightly lower growth forecast than for emerging Asia.

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