Q3

PGIM QUANTITATIVE SOLUTIONS

June 2022

Q3 2022 OUTLOOK

PGIM Quantitative Solutions Multi-Asset Team

EXECUTIVE SUMMARY

Economic Outlook:

- Elevated economic uncertainty, rising inflation, and investor expectations of a downshift in global growth from the stellar rebound of 2021 were already underway at the start of 2022.
- New shocks—Russia's invasion of Ukraine and the reinstatement of COVID-related shutdowns in China—significantly worsened the trend of lower global growth and higher inflation this year.
- Increased inflation pressure has forced central banks to adopt even more aggressive rate hiking postures to recover lost credibility, creating a greater drag on growth.
- Meanwhile, the war in Ukraine is turning out to be a protracted conflict, proving to be a more persistent external shock than investors may have anticipated.
- Reinstatement of lockdowns in China has acted as an impediment to growth and another obstacle to sorting disruptions in global supply chains.
- Europe continues to bear the greatest exposure to both the Russia/Ukraine conflict and to slower growth in China and thus carries the highest recession risk among major developed economies.
- The US economy is relatively more insulated and remains supported by a strong labor market for now. Nevertheless, headwinds including higher gasoline prices, negative real wage growth, and negative wealth effects from declining financial markets persist.
- Significant fiscal drag and signs that the previously red-hot housing market is slowing under the weight of higher mortgage rates and low affordability provide additional headwinds for the US.
- Central banks continue their attempts at walking a tightrope, looking to balance an intensifying inflation problem with increasing risks to growth stemming from multiples shocks and policy tightening.
- After initially misjudging the inflation problem as "transitory" and thus facing credibility challenges, central banks are likely to front-load rate hikes, increasing the risks of policy overtightening and economic downturn.

Market Outlook & Investment Strategy:

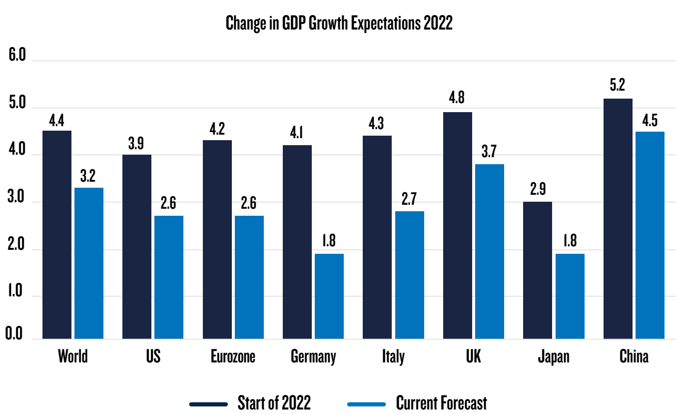
- Rising recession fears gripped global markets this quarter as an unpleasant combination of macro events led stocks into bear market territory and investors assumed a "risk off" stance across most asset segments.
- Declines in bonds (the flip side of higher rates) were also substantial with the bond bear market growling even louder. The Bloomberg Global Aggregate Index extended its losses, falling 15% from its January 2021 high, the biggest drawdown since 1990.
- The decline in stocks was driven primarily by the significant compression in earnings multiples.
- All major equity regions are now trading at a discount to their 10-year averages; however, multiples could see more downward pressure in the near term as inflation runs hot and central banks stay vigilant.
- Corporate earnings have been a key pillar of support for stocks during the recovery from the pandemic and analyst forecasts for 2022 are still upbeat. However, we see significant scope for earnings disappointments in the second half given tighter financial conditions and macro headwinds.
- US dollar strength and souring CEO confidence underscore the risks of downward revisions to US corporate earnings expectations.
- Commodities still stand out as a shining-star asset class and an attractive hedge in the current inflation-prone economic context.
- Beyond near-term volatility, bonds may consolidate as the summer unfolds, especially if investors gain visibility that the inflation rate is following growth lower.
- The tough macro environment argues for caution on fixed income risk assets. However, some bond segments exhibit very attractive value (emerging market debt), while others have yet to fully price in recession risk (US high yield debt).
- Despite significant equity market declines and improved valuations, we remain cautious on stocks due to the combination of heightened recession risk, hawkish central banks, and significant risk of corporate earnings downgrades.

Stagflation is Here. Is Recession Next?

The Russian invasion of Ukraine and recent pandemic-induced shutdowns in China have pushed global inflation significantly higher and slowed growth in the first half of 2022. Although elevated economic uncertainty, rising inflation, and investor expectations of a downshift in global growth from the stellar rebound of 2021 were already underway at the start of 2022, the new shocks significantly worsened these trends. This drove inflation even higher, forcing central banks to adopt increasingly aggressive rate-hiking postures, creating a greater drag on growth. Figures 1 & 2 show the revisions to consensus growth and inflation forecasts since the start of the year.

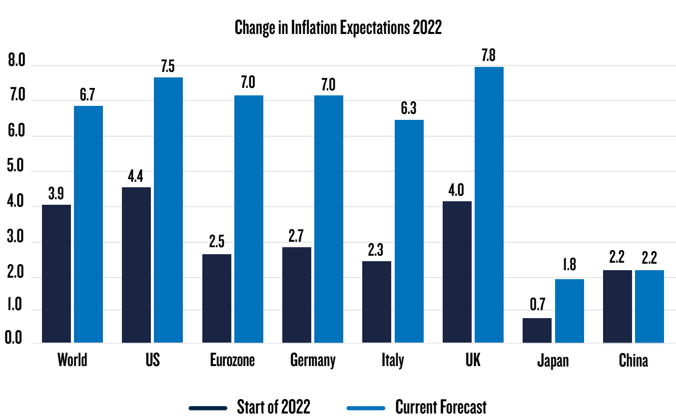
Figure 1 & 2: Growth and Inflation Forecast Revisions

Economists Slash Growth Forecasts



Source: Bloomberg as of 6/13/22.

Big Increase in Inflation Forecasts



Source: Bloomberg as of 6/13/22.

The war in Ukraine is turning out to be a protracted conflict. After more than 100 days of fighting, Russian forces reconstituted themselves in the east and dug in, with a consolidated hold on around 20% of Ukrainian territory. Ukraine will likely hold out in the rest of its territories outside the Donbas with assistance from NATO countries. The Russian economy took a significant hit following severe economic and financial sanctions imposed by the US and its allies. The tightening of sanctions also closed the loopholes for debt payments, putting Russia closer to a sovereign default on its external debt.

China's ongoing zero-COVID policy led to reinstatement of lockdowns, significantly slowing the pace of second-quarter growth. Stringent measures in major cities including Shanghai and Beijing have depressed the service sector and lowered consumption spending. Meanwhile, auto exports declined amid disrupted supply chains. The real estate sector remains under pressure as strict regulations have led to further liquidity tightening. While monetary policy is expected to be supportive and policy rates have been cut since late last year, the scope for additional cuts is limited. Overall, growth remains on track to significantly slow this year before improving gradually in 2023.

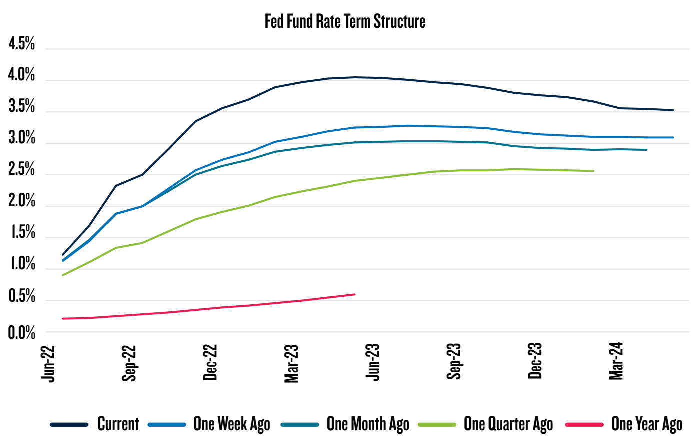
Europe continues to bear the brunt of both the fallout from the Russia/Ukraine conflict as well as the impact of slower China growth. Eurozone business confidence has fallen sharply following the Russian invasion, and the spike in inflation has cut into households' purchasing power. While fiscal policy is providing some support from rising energy prices to businesses and consumers, the potential interruption of oil and gas flow from Russia remains a big risk. Although the European Union has considered imposing a full embargo on Russian oil and gas, a ban has yet to be implemented, with some countries raising concerns that it would trigger an extreme energy crisis for those heavily reliant on Russian energy. The consensus forecasts for European GDP growth show a recovery after a sharp slowdown in the first half. However, this is expected to be modest, and we see significant downside risks to these forecasts.

Despite lower growth expectations, agricultural and energy prices have risen sharply due to acute supply chain concerns. Gasoline prices have spiked in the US, due to both the rise in crude prices and tight production capacity. US consumer fundamentals remain supported by a strong labor market, which continues to churn out jobs and maintains a rising labor force participation rate. However, consumers are facing lower real disposable incomes due to strengthening inflation in non-discretionary items such as food, energy, and rent; and there have been significant negative wealth effects from declines in financial markets. Meanwhile, we are experiencing significant fiscal drag and the red-hot housing market is showing signs of slowing under the weight of higher mortgage rates and low affordability for first-time home buyers.

Near-term inflation expectations have been pushed higher even as medium-term expectations remain quite elevated. The moderation of actual inflation from very elevated levels is likely to be more gradual as the war in Ukraine has quashed hopes that the inflationary surge would subside quickly. The initial surge in 2021 was concentrated in goods prices, as the pandemic recovery boosted goods demand amid supply chain disruptions. While goods price inflation still remains elevated, moderating demand and some easing of supply constraints have started to reduce this pressure. However, services inflation has been rising at a steady pace over the past several months as reopening of the service sector boosted labor costs. Furthermore, intense commodity price pressures driven by disruptions in production are pushing up food and energy prices paid by the consumer. While wage growth is also picking up, the pace is not keeping up with inflation, at least for now. Thus, concerns about a wage-price spiral have diminished from earlier in the year. Still, declining real wage growth is a negative for consumption spending. Inflation expectations have ratcheted higher from the already elevated levels for major developed economies such as the US, Eurozone, and the UK. Japan and China remain the significant exceptions as inflation there remains subdued.

With measured inflation continuing at high levels, major central banks are getting more aggressive in order to prevent higher inflation expectations from getting entrenched. Shortly before its early-June meeting, the Federal Reserve's (Fed) plans to consider a 75-basis point (bps) rate hike, rather than the 50bps that had previously been signaled, was leaked to the press. After following through on the larger rate hike, however, Chairman Powell suggested more flexibility regarding whether future rate hikes would be at the 50bps pace or the 75bps level, highlighting the importance of seeing a downward trend in monthly inflation. Nevertheless, market expectations for the Fed Funds rate are now at around 3.60% for year end, roughly 90bps higher than before the May CPI release that showed inflation to be stronger than anticipated (Figure 3). Meanwhile, the European Central Bank (ECB) has confirmed that it will start its hiking cycle in July and kept the option open for larger rate hikes. To address widening bond spreads in Italy and the rest of the periphery, the ECB has announced its intention to create a new backstop, but details are sparse thus far. The Bank of England (BOE) had been more proactive in hiking rates earlier in the year but has not kept pace with the Fed's recent increases. At its mid-June meeting the BOE signaled that a 50bps hike is likely in August, helping to boost the pound.

Figure 3: Fed Still Playing Catch-Up After Policy Mistake

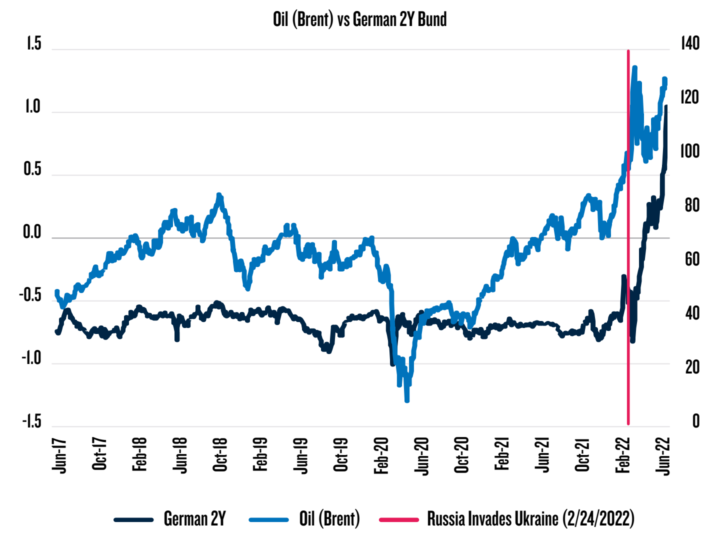


Source: Datastream as of 6/14/22.

In Emerging Markets (EM), inflationary pressures remain high, with inflation expected to peak only in the second half of the year. EM central banks have already been tightening for most of last year and into this year, and policy rates are now above pre-pandemic levels outside of Asia. Central banks are likely to maintain their hawkish stances amid the continued upward pressure from inflation. Latin American central banks are possibly closer to the end of their rate hike cycle, while major Eastern European central banks, including Poland and the Czech Republic, continue to hike rates amid the ongoing attempts to stem domestic inflation and keep their currencies stable. China remains the exception within EM. With low inflation and risks to growth, the People's Bank of China continues to cautiously ease monetary policy to support growth given weakness in the property market and in domestic demand.

PGIM Fixed Income notes that the risks to growth from central bank hawkishness and the war in Ukraine can be nicely proxied by the German 2-year Bund yield and the price of Brent crude oil (Figure 4). Based on these measures, growth headwinds are only intensifying.

Figure 4: No Relief from Central Bank Hawkishness and Ukraine War Impact



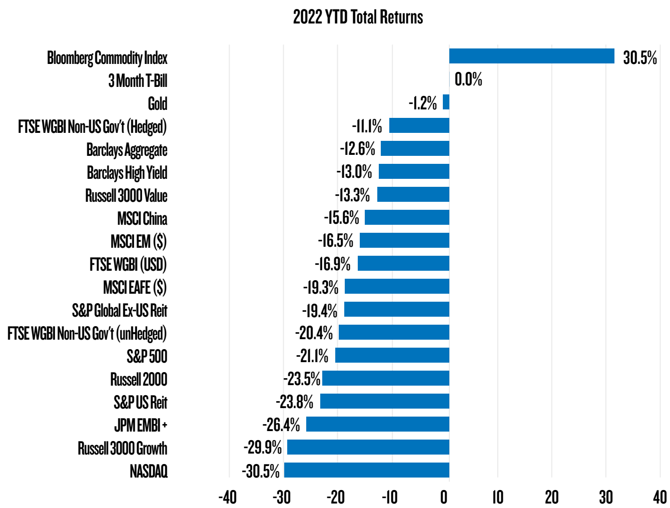
Source: Datastream as of 6/14/22.

Central banks continue their attempts at walking a tightrope, looking to balance an ever-more intensifying inflation problem with increasing risks to growth from the Russia/Ukraine war, China's lockdowns, and potential for policy overtightening. The changing drivers of inflation have led major central banks to revise their thinking after initially misjudging the situation as "transitory." Faced with credibility challenges, central bankers are likely to front-load rate hikes, increasing the risks of policy over-tightening and economic downturn.

Weathering the Storm

Rising fears of recession gripped global markets as the Fed responded to May's higher CPI report by stepping up its efforts to bring intensifying inflation under control. The knock-on effects on prices and supply chain disruptions continued, driven by Russia's invasion of Ukraine and renewed COVID lockdowns in China, intensifying inflation worries even as signs of weaker global growth emerged. This unpleasant combination of events led to a particularly brutal first half in global financial markets (Figure 5). Equity markets fell sharply during the second quarter, after experiencing smaller declines in the first quarter, pushing stocks into bear market territory. Total drawdown for the S&P 500, NASDAQ, MSCI EAFE, Eurostoxx 50, and MSCI Emerging Markets indexes from the highs of 2021/ early 2022 through June 21, 2022, were 22%, 31%, 14%, 21%, and 25%, respectively.

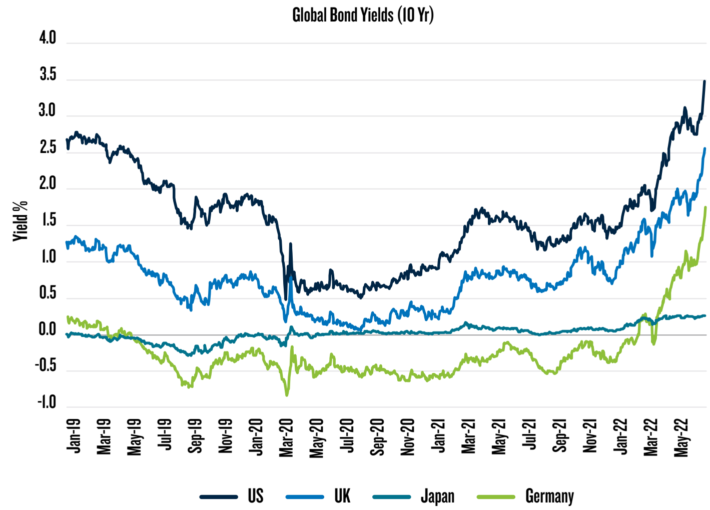
Figure 5: 2022 Performance: First Half Bloodbath



Source: FactSet as of 6/14/22.

Declines in bonds were also substantial as the bond bear market continued to roar. The Bloomberg Global Aggregate Index extended its losses, falling 15% from its January 2021 high, the biggest drawdown since 1990. With central banks turning ever-more hawkish in their quest to tame surging inflation, yields across the curve surged even higher after their brutal rise in Q1 (Figure 6). The 10-year Treasury note yield began the year at 1.5%, increased to 2.3% by the end of the first quarter, and rose further to nearly 3.5% in late Q2 (as of 6/14). The yield on the 2-year Treasury note, which reflects changes in the policy environment, was generally rangebound for most of the quarter before climbing more than 50bps after the Fed signaled a larger-than-expected rate hike for its June meeting. The 2-year yield jumped to approximately 3.4%, rising from 2.3% at the end of Q1 and just 0.7% at the beginning of the year.

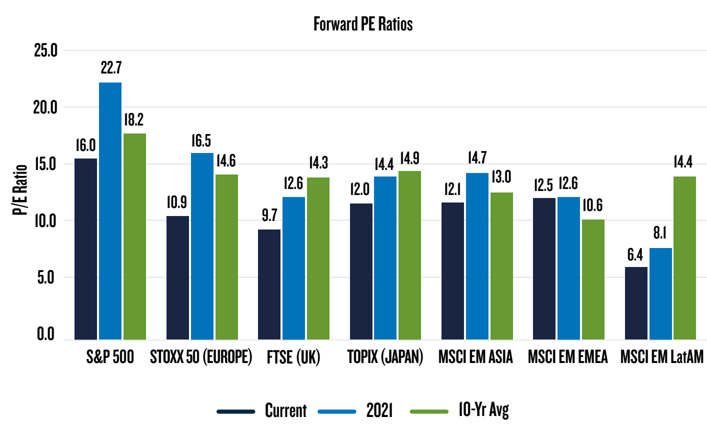
Figure 6: Bond Bear Market Intensifies



Source: Datastream as of 6/14/22.

The decline in stocks was driven primarily by the significant compression in earnings multiples. The forward PE ratio on the MSCI World Index, for example, fell from 20.3 at the end of 2021 to 15.4 (as of June 10th), a decline of roughly 24%. Even the S&P 500 Index, which was trading at a premium to its 10-year average on forward earnings earlier in the year, is now at a discount. Amid the sharp interest rate hikes, markets have priced the higher policy rates into valuation multiples (Figure 7). Among international markets, the major EAFE components – Eurozone, UK, and Japan – all trade at valuations which are at a discount to their 10-year averages. Emerging Market valuations have improved as well, with Latin American equities appearing particularly cheap—currently trading at a 56% discount to history. While stock multiples plunged spectacularly in the first half, they could still see continued downward pressure in the near term as inflation continues to run hot and central banks stay vigilant.

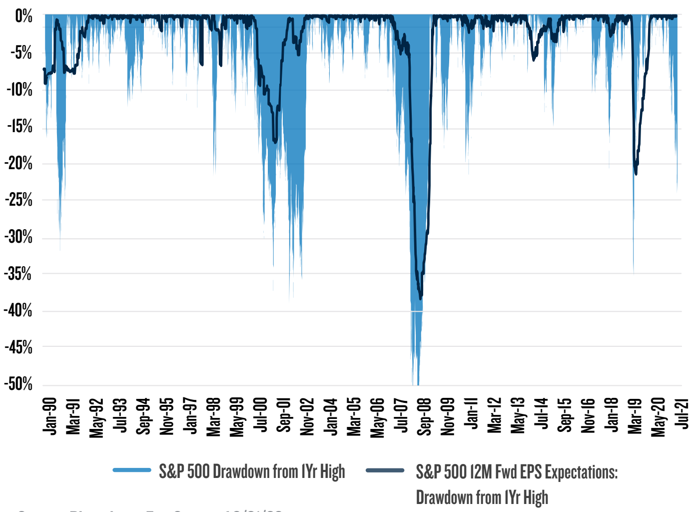
Figure 7: Significant Decline in Equity Valuations



Source: Bloomberg as of 6/16/22.

Corporate earnings have been a key pillar of support for stocks during the recovery from the pandemic, with 2021 proving to be a banner year for earnings growth. Analyst expectations for global earnings growth in 2022 remain upbeat even as markets have experienced large drawdowns due to multiple shocks. US earnings expectations for 2022 have actually been revised higher since the beginning of Q2, while expectations for 2023 have remained steady. While part of the strength is driven by the Energy sector, earnings outside the sector are also forecast to hold firm. We are skeptical about these estimates and see a high likelihood of earnings disappointment in the second half of the year given tighter financial conditions and other headwinds (Figure 8). US dollar strength and sharply deteriorating CEO confidence underscore the risks of downward revisions to S&P 500 earnings estimates.

Figure 8: Big Discrepancy: Earnings Expectations Don't Reflect Equity Market Decline

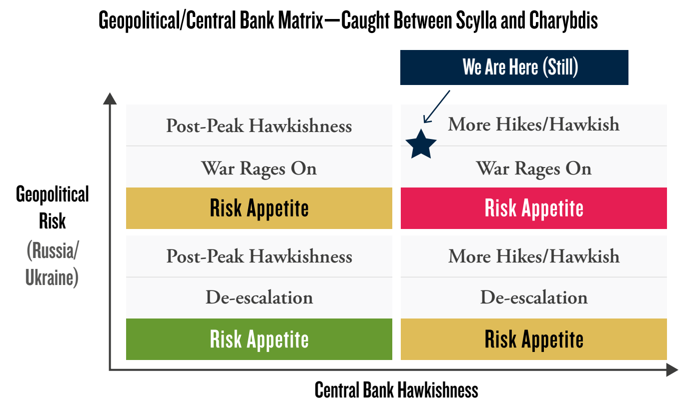


Source: Bloomberg, FactSet as of 6/21/22.

With the ongoing deterioration in the global macro environment, we are cautious in the near-term outlook for riskier fixed income sectors. Nevertheless, some sectors have more attractive risk-reward profiles than government bonds. Emerging Market (EM) debt experienced a sharper drawdown during the first half of 2022 than US stocks, falling 29% from last year's peak. EM hard currency yields rose to about 7.5% by late June and are now above the peaks seen in March 2020 and November 2018, making them very attractive from a valuation perspective. However, spreads are likely to remain pressured as long as US rates continue to be repriced upward. Even though most EM central banks are relatively more advanced in their hiking cycles, weaker EM currencies and higher energy prices increase the upside risk to EM inflation, which will put pressure on EM central banks to retain a hawkish stance for longer. US corporate high yield bonds have held up better by comparison so far this year, with a decline of about 13%. Spreads on high yield debt have also risen but are still below their historical average. Therefore, the segment is not yet cheap and is not fully pricing in recession risk. US companies are somewhat insulated from the war in Ukraine and the slowdown in China. While high yield debt is likely to benefit from the Energy sector, which represents roughly 13% of the Bloomberg US Corporate High Yield Index, consumer cyclicals (~21% of the index) could prove to be a headwind amid economic turbulence.

We remain positive on commodities and continue to believe the bull market here is still young. Supply-demand imbalances are not likely to be easily remedied in the near term. Russia's invasion of Ukraine has led to a negative supply shock across all commodities: oil, gas, coal, fertilizers, precious and industrial metals, and agriculture. With the war dragging on, and with Russian threats to cut energy supplies, supply constraints are likely to be persistent in the coming quarters. Although some signs of weakening in the developed economies may provide a modest offset, pandemic-weary consumers remain eager to travel. This should boost summer seasonal demand and be supportive for commodities. Real-time US activity data on time spent outside the home, for example, are still approximately 4% below pre-pandemic levels, suggesting still-pent-up demand. Inventories across the commodity complex remain well below historical averages. Furthermore, planned reopening in China during the second half, following rolling COVID lockdowns in the second quarter, could provide additional support to commodities.

Figure 9:



Source: PGIM Fixed Income as of May 2022.

Beyond the near-term yield volatility, bonds may consolidate in late summer on further visibility into the inflation and growth trajectory. Overall, we remain bearish on the outlook for sovereign debt over a longer-term horizon and we think yields are likely to rise over the next few years. So long as markets remain gripped by the dual headwinds of intense geopolitical tensions and stepped-up central bank hawkishness, we expect risky assets to remain under pressure (Figure 9). Despite significant equity market drawdowns and improved valuation multiples, we remain cautious on equity markets due to the combination of heightened recession risk, hawkish central banks, and significant risk of earnings disappointment.

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*Assets under management (AUM) are based on company estimates and are subject to change.

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