

Q2 2023

LONG AND VARIABLE LAGS



GLOBAL
MARKET
OUTLOOK



Long and variable lags

Growth has been resilient, but inflation is receding only slowly, and central banks have not finished tightening. Recession indicators still flash warning signals. This creates a positive backdrop for government bonds and uncertainty for equity markets.



Our view is that a mild recession in the United States is likely over the next 12-18 months.

Andrew Pease, Global Head of Investment Strategy



Introduction

Economist Milton Friedman famously noted “that monetary actions affect economic conditions only after a lag that is both long and variable.”¹ The current cycle is following this maxim. We have seen the [most aggressive tightening by the U.S. Federal Reserve \(Fed\) since the early 1980s](#), yet payroll gains have averaged 407,000 over the first two months of this year and consumer spending growth is running close to trend.

European and Chinese growth have also surprised positively. The energy shock from the Russia/Ukraine war was supposed to send Europe into recession over the northern winter, but growth has remained positive. The unusually warm winter has boosted economic data in the U.S. and Europe, but there are also fundamental factors at play. Consumers in both regions are benefiting from falling energy prices, job gains and improving real incomes. China is bouncing back following the easing of COVID-19 lockdowns.

It would be unwise, however, to sound the all-clear on the global growth outlook. Those long and variable lags are still in play. Historically, it has taken an average of around two and a half years after the Fed’s initial rate hike for a recession to commence. The first hike in this cycle was in March 2022.

The [collapse of Silicon Valley Bank \(SVB\)](#) in mid-March highlights the dangers from aggressive central bank hikes. SVB’s main problem was its large holding of long-duration bonds, which lost value as bond yields rose through 2022. It bears little resemblance to the bank failures during the financial crisis in 2008. These were mostly due to losses on mortgage-backed securities. The Fed’s new [Bank Term Funding Program](#) should prevent SVB’s problems from flowing onto other banks, but the episode highlights the dangers caused by rapid monetary tightening.

The economic data renaissance combined with the threat of financial sector instability leaves central banks with difficult choices. High inflation means more rate hikes are likely, but worries about financial stability argue for moving cautiously.

The banking system shock should also act as a form of monetary tightening through tighter lending standards. We expect that the Fed will undertake one to two more 25-basis-point rate hikes in the next few months.

Every cycle is different, but this one stands out because of the pandemic, which disrupted supply chains and pulled forward goods demand during the lockdowns. Labor markets tightened quickly due to worker shortages caused by early retirement, increased long-term illness and lower immigration. Large government support packages meant U.S. consumers were sitting on more than US\$2 trillion of additional savings when lockdowns were eased in late 2021. Add on the energy shock from the Russia/Ukraine war and the result is an inflation spike that has been larger and more persistent than most forecasters anticipated.

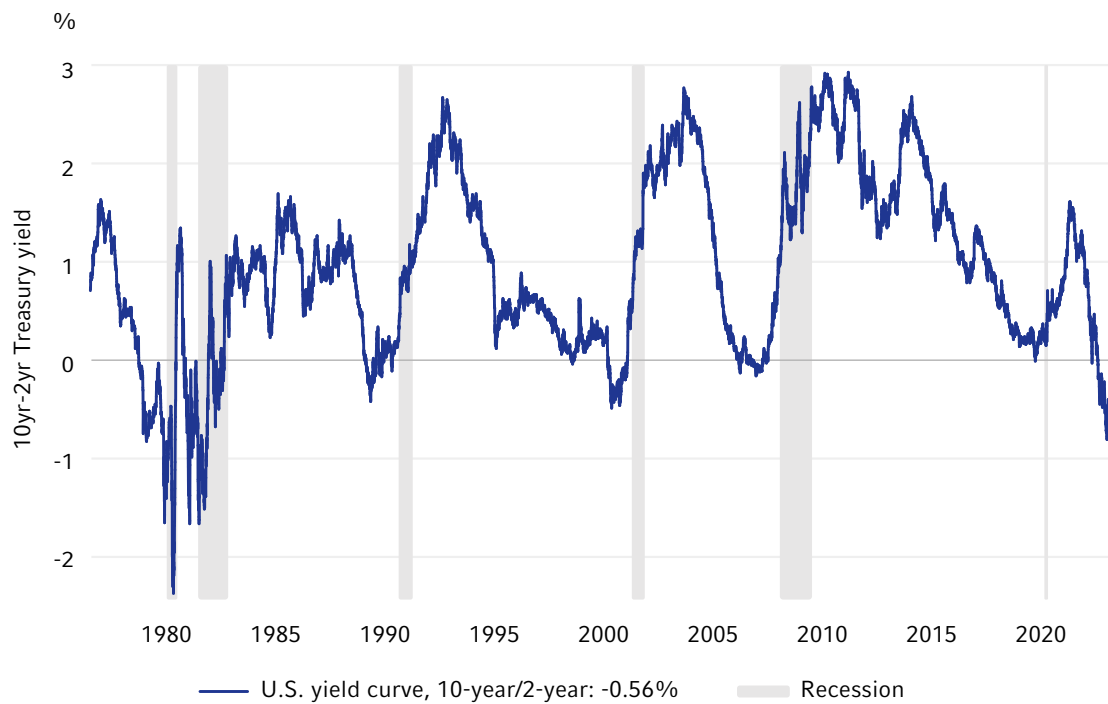
When could a recession strike the U.S.?

Our view is that a [mild recession in the United States is likely](#) over the next 12-18 months. The inverted yield curve is the indicator that most clearly signals recession risk. The chart below shows the spread between the 10-year and 2-year Treasury yield. A negative spread (inversion) means that bond investors think the Fed has tightened by so much that interest rates will be lower in the future.

Strong household and corporate finances are likely to limit the downturn to a mild recession. A mild recession, however, implies that the cycle will be a headwind for equity markets as earnings and economic indicators deteriorate. It is a more favorable environment for government bonds, which should provide investors with good diversification potential.

¹ Journal of Political Economy, Volume 69, Number 5, Oct 1961.

Inverted U.S. yield curve signals recession risk



Source: Refinitiv® DataStream®, as of March 15, 2023.

U.S. labor market is too hot

The [overheated labor market](#) is the biggest imbalance in the U.S. economy. Wage inflation has spiked to a 40-year high and there are a record two job vacancies for every unemployed person.

How far does the Fed want wage inflation to fall?

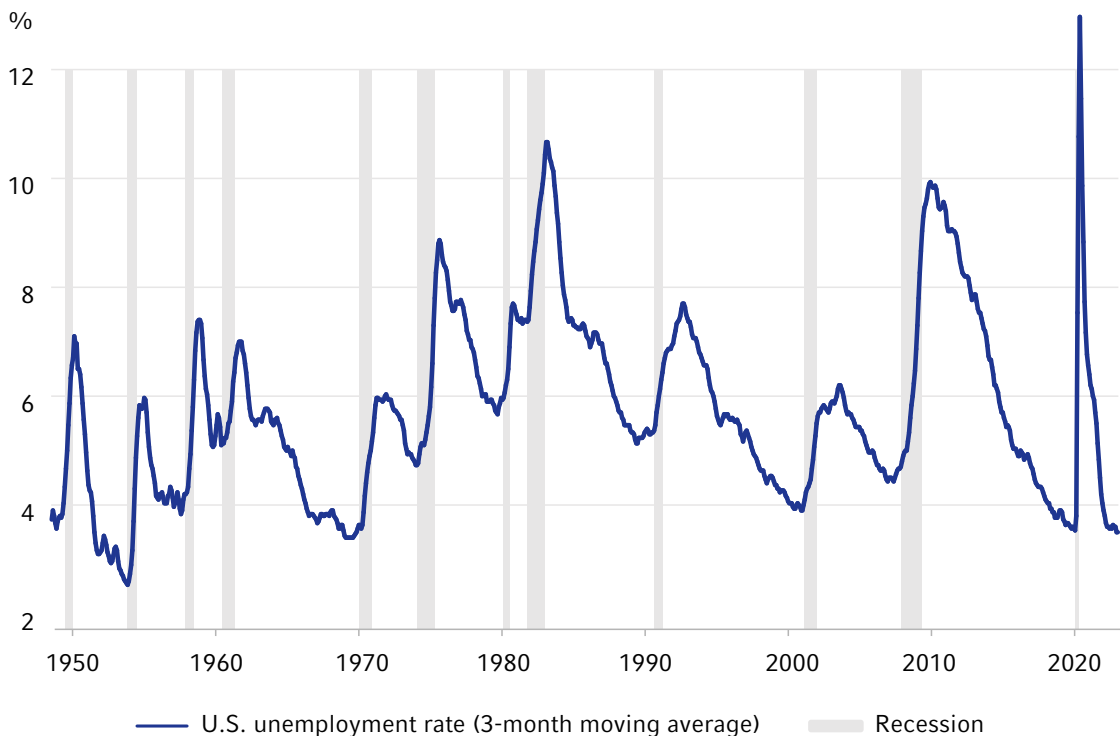
The [Fed will only back off from restrictive policy](#) when it is confident the labor market has cooled by enough to bring wage inflation into line with its 2% target for consumer price inflation. Most wage measures are running at around 5-6% annual growth. The Fed would prefer wage inflation to be below 4%.

The unemployment rate at 3.6% in February is the lowest since the 1960s. We estimate that it needs to rise by at least a percentage point to generate the cooling in wage growth required by the Fed. Unemployment, however, tends to continue rising once it starts to go up. Households respond

to rising unemployment by cutting back on consumption. Businesses trim investment spending. The resulting fall in aggregate demand leads to higher unemployment and less spending. Over the post-World War II period, the U.S. economy has experienced a recession every time the three-month moving average of the unemployment rate has risen by more than a third of a percent.

The Fed faces a daunting task to achieve a soft landing that sees wage growth and inflation cool without causing a recession. Equity investors may cheer the initial signs of labor-market cooling on hopes for a Fed pivot. Historical experience, however, suggests that the landing will be difficult to accomplish.

When unemployment begins rising, it usually continues rising



Source: Refinitiv® DataStream®, as of February 23, 2023.



The Fed faces a daunting task to achieve a soft landing that sees wage growth and inflation cool without causing a recession.

Andrew Pease

Profit margins under pressure

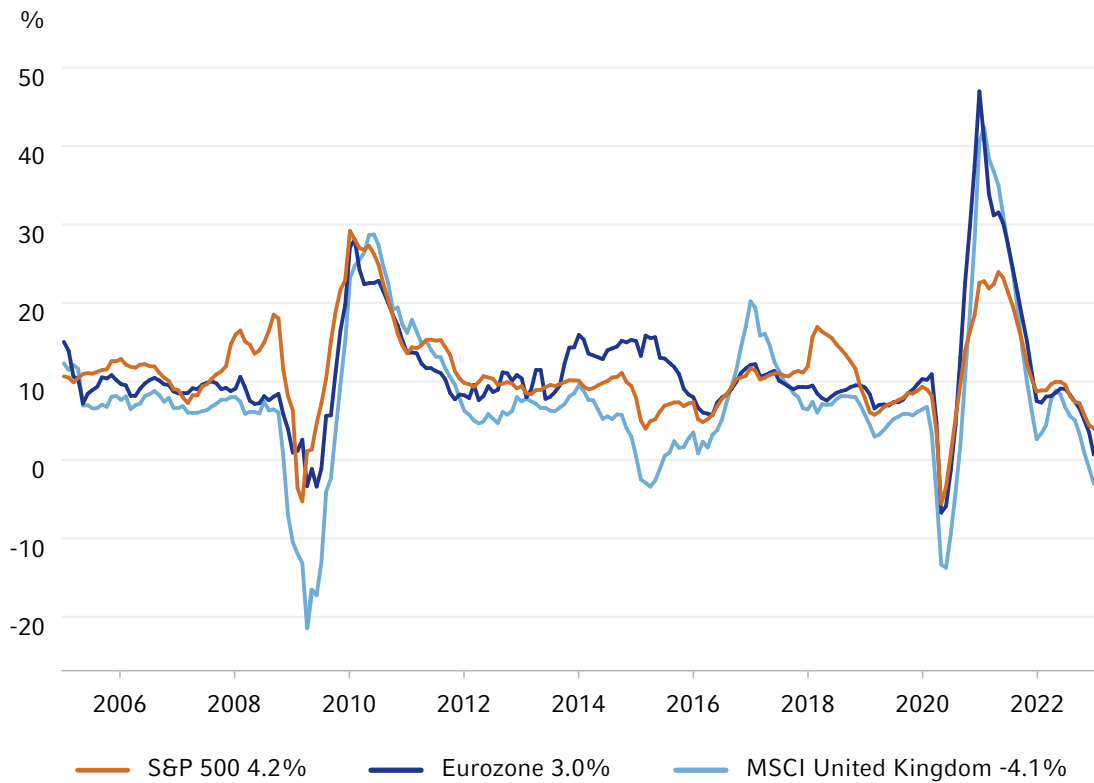
Corporate earnings are another watchpoint for investors this year. Earnings growth peaked in most regions in early 2022 and has trended lower since. This has in part been due to moderating sales growth as economic growth cools, but falling margins have also played a role. Margins were boosted by rising inflation during 2021 and early 2022 as final pricing power improved, but cost inflation, particularly labor costs, remained subdued.

What are the expectations for earnings growth?

That process, however, has been in reverse over the past year. Declining inflation means firms are losing pricing power, but labor costs are declining more gradually. The chart below shows the 12-month-ahead consensus earnings expectations from the Institutional Broker Estimate System (I/B/E/S). Industry analysts have become more cautious on the earnings outlook for the next year but are not yet anticipating the 15-20% decline in earnings per share (EPS) that typically occurs during a recession.

Forward price-to-earnings multiples have declined significantly over the past two years (the S&P 500® multiple has fallen from 23 times to 17 times), so to some extent, investors have already factored in a decline in earnings. The current round of surprisingly strong economic data could see earnings growth expectations track broadly sideways for the next few months. A further downturn in earnings expectations seems likely, however, as the Fed achieves its goal of reducing inflation by slowing demand.

Industry earnings expectations have become more cautious



Source: Refinitiv® DataStream®, Russell Investments as of March 7, 2023. I/B/E/S = Institutional Broker Estimate System.

The current round of surprisingly strong economic data could see earnings growth expectations track broadly sideways for the next few months.

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Canada market perspective

With one eye on inflation and the other on housing, the Bank of Canada (BoC) has put policy on pause. This is an implicit nod toward the housing market as the key risk to financial stability, despite above-target inflation. We believe the pause is warranted.

Narrative delayed

The expectation that an aggressive BoC rate-hiking cycle renders undue stress on the hugely indebted household sector, which ultimately contributes to tipping the economy into a recession, has yet to play out. In the fourth quarter of 2022, domestic demand grew by 1%, hardly indicative of a recessionary environment. Nevertheless, the stresses are there and the debt exists, so the recession narrative is possibly delayed, but likely not derailed. The BoC has "conditionally" paused its rate-hiking cycle for a reason. It expects the cumulative effects of prior rate hikes to slow demand – and the overall economy – enough to bring down inflation. Alternatively, the BoC reserves the right to resume rate hikes if economic conditions are more resilient and inflation stickier than forecasted. While we don't rule out that scenario, the bar is high. Credit metrics suggest evolving financial vulnerability. For instance, household and business insolvencies and delinquency rates are rising, indicating economic stress is building: see Chart 1.

We are also monitoring the projected policy divergence between the BoC and the U.S. Federal Reserve (Fed), which has lessened since the collapse of U.S. lender Silicon Valley Bank (SVB), but persists. Markets are pricing a more aggressive Fed path relative to the BoC, which has pressured the Canadian dollar (CAD) lower. BoC Senior Deputy Governor Carolyn Rogers commented that the central bank "thinks global, but acts local," suggesting that Canada's close economic linkages to the U.S. economy can't be ignored, though ultimately, domestic conditions matter most.

Yet, it's rare for the BoC target rate to be significantly out of step with the Fed. The last time policy diverged widely was in the 1980s. Then, the average BoC target rate exceeded the Fed rate by more than 200 basis points (bps), as shown in Chart 2. However, the 1980s aren't a perfect comparison to today. Inflation, on average, was hotter in Canada by about 120bps, which justified the differentials and tighter BoC policy. Chart 2 also shows that policy divergences have been rare over the last three decades, along with narrowing inflation differentials. The current situation is not one of tighter BoC policy, as in the 1980s, but the opposite: the markets are pricing a more hawkish Fed relative to the BoC by about 80bps as of March 10, though narrowed since the collapse of SVB. Nevertheless, such a divergence favoring the Fed target rate hasn't occurred since 2007, before the Great Recession of 2008/09.

The U.S. has a tighter labor market, while headline and core inflation are 50bps and 60bps, respectively, higher in the U.S. relative to Canada as of January, all of which support a higher U.S. target rate. The concern relates to currency. The CAD has depreciated roughly 10% against the U.S. dollar over the past year², and could decline more if policy divergence persists. The implication is that a weaker CAD raises the upside risks for inflation via higher import prices. While this is a crucial watchpoint, the expected slowing of the economy should allow the BoC to stay sidelined over the coming months. Ultimately, if our view of a mild recession is realized, though admittedly it may be delayed, the next move by the central bank may be rate cuts by year-end.

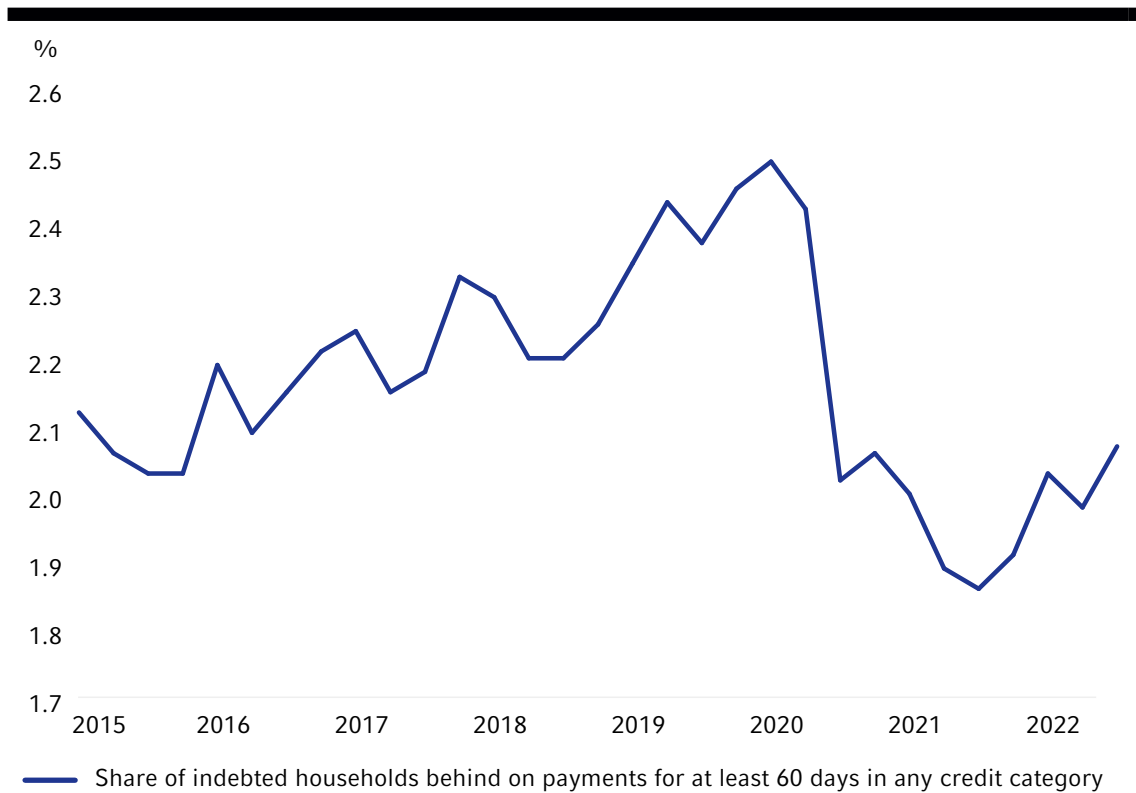
Financial markets outlook

Global conditions influence the Canadian 10-year yield, but with the BoC expected to stay on pause, there is less upside to the Canadian 10-year yield relative to the U.S., where market pricing for the Fed is more hawkish. The Canadian 10-year yield was trading near 2.8% as of March 10, about 90bps below its peak of about 3.7% from last October. While a retest of the prior peak is possible, rising recession risks will restrict a substantive rise, ultimately improving bonds' attractiveness from a total return and diversification perspective.

While Canadian equities have outperformed the U.S. by about 14% in local currency terms over the last two years as of March 9, domestic shares have underperformed by almost 100% over the past 10 years. Catch-up performance isn't the only reason we have a favorable outlook for Canadian equities relative to the U.S. Better valuation and improving medium-term prospects for commodities strengthen the case. Still, over a tactical horizon of the next 12 months, the Canadian equity market's cyclical nature makes it vulnerable to a recession-driven sell-off. Overall, the business cycle outlook keeps us cautious about Canadian equities over the near term.

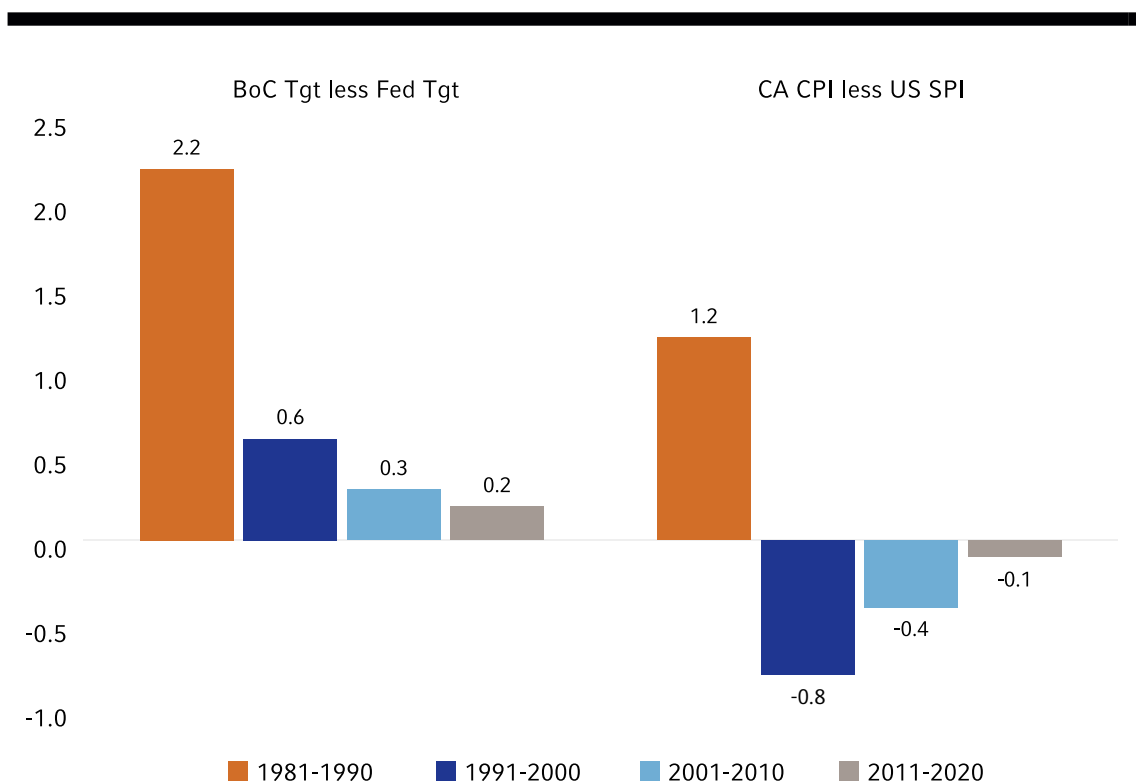
² Source: Refinitiv® DataStream®, performance period measured from March 30, 2022, to April 8, 2023.

Chart 1: Household delinquent at least 60 days



Source: Bank of Canada, Russell Investments. As of Q3 2022. Chart reflects share of indebted households behind on payments for at least 60 days in any credit category.

Chart 2: BOC-Fed rate differential vs. Canada-US inflation differential



Source: Refinitiv® DataStream®, Russell Investments. BoC=Bank of Canada, Fed=U.S. Federal Reserve. Tgt=Target, CPI=Consumer Price Index.

Regional snapshots

United States

The U.S. economy is sending mixed messages. Several leading indicators are rolling over. The manufacturing sector is contracting, bank lending standards are tightening, companies are shedding temporary staff and hours, profit margins are compressing and the Treasury yield curve is very inverted. In contrast, many important coincident indicators were stronger than expected in recent months. Consumer spending, headline job growth, wage inflation and price inflation all surprised to the upside in early 2023.

The Fed remains laser-focused on cooling the labor market and winning its inflation fight, so resilience in these key areas pressures the Federal Open Market Committee (FOMC) to consider rate hikes even into stresses in the banking system. A very restrictive monetary policy stance and the difficulty of cooling the labor market without causing a large rise in unemployment leads us to conclude that a U.S. recession is more likely than not in the year ahead.



Eurozone

The eurozone economies have surprised with their strength and avoided a recession that [seemed inevitable late last year](#). The mild winter has reduced energy demand and [lowered energy prices](#), and a range of economic indicators have positively surprised. The sting in the tail from better economic growth is that the European Central Bank (ECB) has taken policy into restrictive territory. The ECB lifted the policy rate by 50bps to 3.0% in March and at least one more rate hike is possible. Inflation, excluding energy prices, continues to rise with core inflation reaching 5.3% in the year to January. Labor demand is strong and wage growth is picking up.

China is an important export market, and its reopening will provide a further boost, particularly for Germany and Spain. The longer-term outlook is less positive, however. Monetary policy is on track to become very restrictive and next winter will provide another test of how far Europe has transitioned from Russian energy dependence. The eurozone will also be vulnerable to a recession in the United States.

Positive economic surprises and a relatively [hawkish ECB](#) are supportive for the euro, which is cheap on a purchasing-power basis. Eurozone equities have been strong performers over the past six months. They can potentially extend these gains for several more months but should eventually face the cycle challenges of tight monetary policy and recession risk.



United Kingdom

The UK economy, like the rest of Europe, is performing better than expected and a recession is no longer anticipated in the near-term. The tailwinds have been the mild winter, lower energy costs, fiscal support to offset energy prices and economic resilience in Europe, which is the UK's largest export market.

The medium-term headwinds are still in place, however, from rising interest rates and a [tight labor market](#) that is generating wage growth which is too high to bring inflation back to the Bank of England's (BoE) 2% target.

There are signs that the economy is beginning to cool and BoE Governor Andrew Bailey has recently signaled a less aggressive stance on further rate hikes. Markets expect one more 25 basis-point tightening that will take the policy rate to 4.25%. The BoE seems likely to pause ahead of the Fed and ECB.

The British pound is undervalued against the U.S. dollar but may struggle with further gains in the near term with the BoE becoming less hawkish. Large-cap UK equities, which offer good value, have benefited from their relatively large exposure to health, financials and consumer staples and small exposure to technology firms. These biases may turn into a headwind in the near-term, but UK equities are attractive on a longer-term basis.



Japan

Japan is still on track for modest growth this year, as soft domestic and global demand is offset to some extent by the proximity to China's reopening. The key issue for the Japanese economy is wage growth, and the potential for inflation to sustainably reach the Bank of Japan's (BOJ) 2% target.

We think the [BOJ will make further changes to the yield curve control policy](#) it has been conducting since September 2016. Last December, it raised the band on its 10-year bond target from 0.25% to 0.5%. We expect

further upward moves will occur this year, but a rise in the cash rate is unlikely. Given this dynamic, Japanese bonds do not look attractive as we estimate the fair-value yield for the 10-year bond is around 1%.

The Japanese yen is cheap on a purchasing-power parity basis, should perform well once we reach the end of the global interest rate-hiking cycle, and can provide some diversification benefits in the event of a recession.



China

The [Chinese economy is reopening](#) after the COVID-19 lockdowns. The government has announced a gross domestic product (GDP) growth target of *around 5%*, which was in line with our expectations. Growth this year will be [reliant on the consumer](#), given the slowing global economy and the government's preference to not let property construction aggressively expand.

Chinese consumers have excess savings, but they are notably lower than in developed economies as the Chinese government did not undertake support payments through the lockdown. We need to see signs that the property market is bottoming out for consumer confidence to rebound. There are only tentative signs of improvement so far.

Geopolitical tensions remain elevated, with the most notable development being the U.S.

government's ban on exporting high-end semiconductor chips. These are important for some of the strategic goals for the Chinese economy.

Fiscal policy will be less supportive for the economy than last year. The government has announced that the augmented fiscal deficit (central government plus local government financing vehicles) will modestly tighten this year. Monetary policy, however, will remain accommodative since inflation remains low.

Despite attractive valuations, we remain cautious on Chinese equities. Sentiment has moved too far ahead of the cycle and value fundamentals. Technical indicators suggest the market has overshot to the upside in the near term, and there are signs of overconfidence from the drumbeat of analysts upgrading their forecasts for the Chinese economy.



Canada

The Canadian economy has performed better than expected, supported by exports and domestic demand. Undoubtedly, the resiliency of the U.S. economy has benefited trade, while a milder winter has boosted consumer spending. Despite the apparent optimism, the Bank of Canada (BoC) has turned [cautious about the growth outlook and "conditionally" paused its rate hikes](#), becoming the first major developed market central bank to do so. Monetary policy works with a lag, and the BoC believes rates have risen sufficiently to slow demand and inflation. Moreover, the surge in immigration is expected to contribute to loosening the tight labor market.

Admittedly, inflation remains above the 2% target, and the BoC has communicated that if economic conditions evolve better than expected, rate hikes will resume. It is more likely, however, that the economy cools. Household and business insolvencies and household delinquency rates are rising, indicating economic stress is building. The projected policy divergence between the BoC and the Fed is a watchpoint. Markets are pricing a more aggressive Fed path relative to the BoC, which has pressured the CAD lower, approaching levels that could lift inflation via higher import prices. A mild recession seems likely over the next 12 months, which reduces the odds of further tightening.



Australia/New Zealand

Australian growth should continue to slow through 2023, but recession risk is lower than in the northern hemisphere. Many mortgage interest rates will reset from April, and the increase in mortgage payments will weigh on household consumption. Importantly, many households have substantial home equity which reduces the potential for significant mortgage defaults. The labor market is very tight but is likely to ease through 2023 as labor demand moderates and labor supply increases as immigration resumes. This should keep wage pressure relatively contained. The Reserve Bank of Australia has recently signaled that it is near the end of its tightening cycle, and we believe that Australian government bonds offer attractive valuations. The Australian dollar has seen further selling pressure given the

divergence in central bank policy between the U.S. and Australia and now looks attractively valued.

Recession risk in New Zealand remains elevated, given the elevated levels of household debt and the aggressive policy actions of the Reserve Bank of New Zealand (RBNZ). Even the RBNZ forecasts a recession to occur this year, with a peak-to-trough decline in GDP of around 1% expected. We do not anticipate any meaningful change in fiscal policy from new Prime Minister Chris Hipkins (following former Prime Minister Jacinda Ardern's resignation) and look instead to the general election in October. The National Party (which has been in opposition for six years) leads in the public opinion polls and will get a further popularity boost if a recession does ensue.



Despite attractive valuations, we remain cautious on Chinese equities.

Andrew Pease

Asset-class preferences

Our cycle, value, and sentiment (CVS) decision-making process points to an uncertain equity market outlook and is more favorable on the outlook for government bonds.

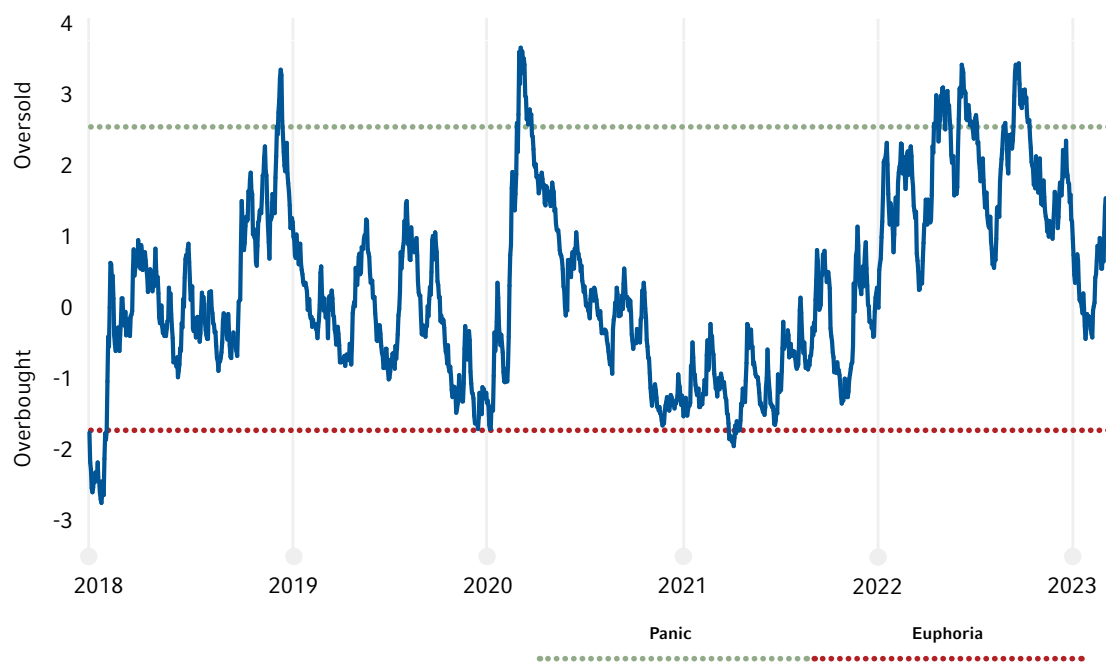
Is the business cycle a headwind for equities?

The cycle outlook (with recessions likely) is a headwind for equity markets. This may improve once it is apparent that the Fed has finished tightening. The turning point will come when interest rate cuts are on the horizon.

Equity market valuation is a question mark. The one-year forward price-to-earnings (PE) multiple for the S&P 500® has fallen from 22 times at the beginning of 2022 to 17.5 times in mid-March 2023. This, however, is still a high multiple by historic standards. Our valuation methodology scores U.S. equities as expensive. Non-U.S. equities are closer to fair value.

Equity market valuation is a question mark. Our composite sentiment indicator for equities is marginally oversold as of mid-March. It had moved to slightly overbought early in the year as equities rallied but reversed on the market volatility following the [collapse of Silicon Valley Bank](#). We judge sentiment as neutral for the outlook.

Composite contrarian indicator signals slightly oversold investor sentiment



Source: Russell Investments. Last observation is +1.42 Standard Deviations, as of March 15, 2023. The Composite Contrarian Indicators for investor sentiment are measured in standard deviations above or below a neutral level, with positive numeric scores corresponding to signs of investor pessimism, while negative numeric scores correspond to signs of investor optimism.

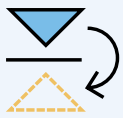
The CVS conclusion for equities is that the cycle is poor, value is expensive to at best fair value and sentiment is neutral.

Are government bonds attractive?

Government bonds are attractive from a CVS perspective. The cycle is turning supportive with inflation set to decline and central banks potentially pausing in the next few months. Value is positive after last year's selloff. Sentiment is supportive, with data from the Commodity Futures Trading Commission (CFTC)

highlighting that most investors hold short-duration positions (i.e., they expect yields to rise). This is supportive from a contrarian perspective.

Specifically, we have the following asset class assessments at the beginning of Q2 2023:



Equities

Limited upside with recession risk on the horizon. Although **non-U.S. developed equities** are cheaper than U.S. equities, we have a neutral preference until the Fed becomes less hawkish and the U.S. dollar weakens.



Emerging market equities

These equities track the performance of the U.S. dollar and a recovery seems likely only once the Fed has stopped tightening and the U.S. dollar begins to decline. China's reopening has helped Chinese stocks rebound, but there are question marks over the longer-term outlook given the headwinds from the property market. For now, a neutral stance is warranted.



High yield and investment grade credit

Spreads have widened following the turbulence caused by the [Silicon Valley Bank collapse](#) and are above their long-term averages. Spreads will come under upward pressure if U.S. recession probabilities increase and there are fears of rising defaults. We have a neutral outlook on credit markets.



Government bonds

Valuations have improved after the rise in yields during 2022. U.S., UK and German bonds offer reasonable value. Japanese bonds are still expensive with the Bank of Japan holding the 50-basis-point yield limit. Our methodology has fair value for Japanese government bond yields at around 100 basis points. The risk of a significant selloff seems limited given inflation is close to peaking and markets have priced hawkish outlooks for most central banks.



Real assets

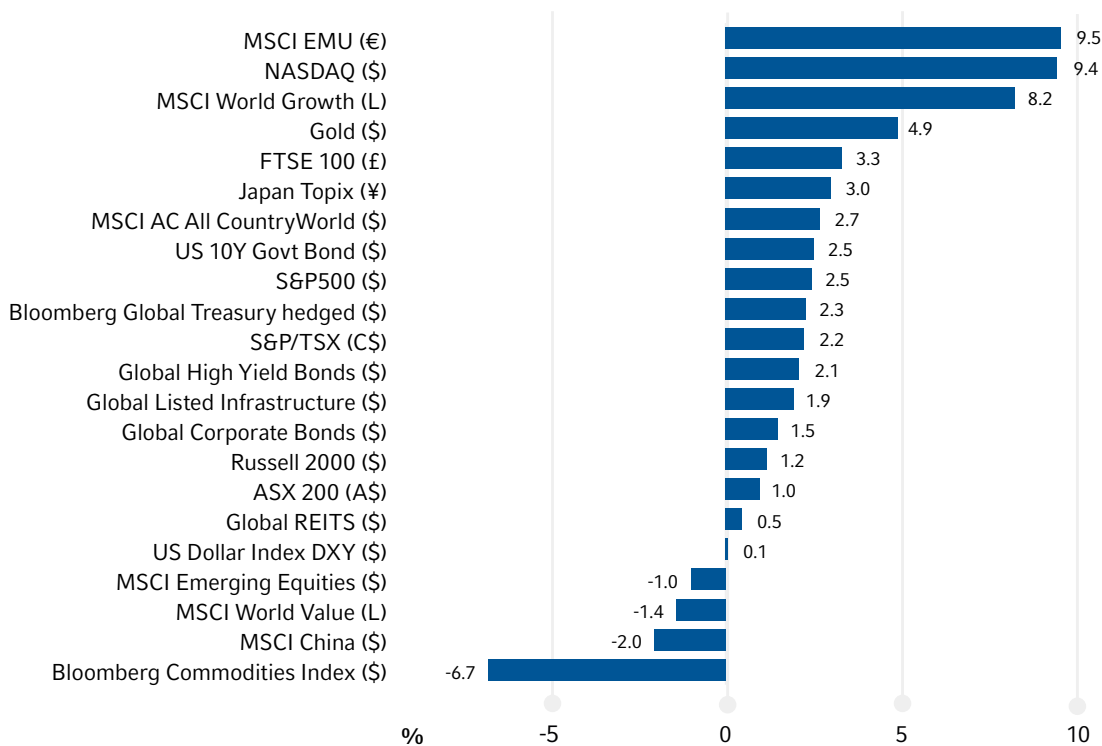
REITs valuations remain attractive relative to infrastructure and global equities remains, although the gap has become smaller. REITs should perform well when interest rates fall, given that real estate fundamentals appear reasonably healthy. Commodities should benefit from the China reopening. The boost is likely to be smaller than for previous China rebounds since infrastructure/construction is expected to drive less of the growth in 2023. The energy outlook is murky, given the demand destruction from a potential global recession and the supply constraints from the sanctions on Russian output. Gold looks fully priced, given its relationship to real interest rates and with inflation risks diminishing.



U.S. dollar

The dollar has risen modestly this year on Fed hawkishness. It could weaken if inflation begins to decline and the Fed pivots to a less hawkish stance. The main beneficiaries are likely to be the **euro** and the **Japanese yen**. The yen could also appreciate strongly if new BOJ governor Kazuo Ueda moves away from the current *yield curve control* strategy.

Asset performance since the beginning of 2023



Source: Refinitiv® DataStream®, as of March 14, 2023. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.



The cycle, value and sentiment conclusion for equities is that the cycle is poor, value is expensive to at best fair value and sentiment is neutral.

Andrew Pease

IMPORTANT INFORMATION

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Currency investing involves risks including fluctuations in currency values, whether the home currency or the foreign currency. They can either enhance or reduce the returns associated with foreign investments.

Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to sub-prime mortgages. Generally, when interest rates rise, prices of fixed income securities fall.

Performance quoted represents past performance and should not be viewed as a guarantee of future results.

The FTSE 100 Index is a market-capitalization weighted index of UK-listed blue chip companies.

The S&P 500® Index, or the Standard & Poor's 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

The Bloomberg Global Treasury Index tracks fixed-rate, local currency government debt of investment grade countries, including both developed and emerging markets. The index represents the treasury sector of the Global Aggregate Index. The index was created in 1992, with history available from January 1, 1987.

The MSCI EMU Index (European Economic and Monetary Union) captures large and mid cap representation across the 10 developed markets countries in the EMU. With 246 constituents, the index covers approximately 85% of the free float-adjusted market capitalization of the EMU.

S&P/TSX Composite Index: The benchmark Canadian index, representing roughly 70% of the total market capitalization on the Toronto Stock Exchange.

FTSE Canada Universe Bond Index measures the performance of marketable government and corporate bonds outstanding in the Canadian market.

Goldman Sachs Commodity Index or S&P GSCI® is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities.

Indexes are unmanaged and cannot be invested in directly.

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