MACRO ENVIRONMENT

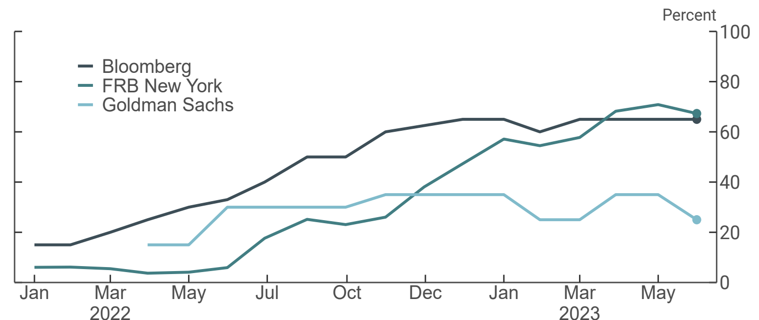
What a difference a year can make. This time last year, the Federal Reserve had just kicked off a tightening cycle that became one of the steepest on record. Recession fears abounded. Equities plunged. This year, by contrast, Q2 saw the first pause in that tightening cycle, indicating that we are nearing the peak in interest rates. And hopes crept up that the US might escape a recession.

Investors cheered. US equities notched an average 8.7% over the quarter. Global equities, excluding the US, also gained overall, pulled up by an astonishing 18.9% rise in Japan's Nikkei. In Europe, the mood was darker, with inflation remaining sticky and the economy weak, notably in Germany, Europe's powerhouse, and in the UK, where the negative effects of Brexit became clearer. In China, consumers continued to save rather than spend, with the economy continuing the disappointing streak of Q1. The damage to confidence from the pandemic years of drastic and sudden lockdowns and unexpected policy shifts appears to have been greater than first thought. Beijing has reacted by easing monetary policy and regulatory rules on property lending. These measures have not sufficed to boost consumption or revive the property market, and uncertainty persists about the government's promise to welcome private sector investment and success.

Towards the end of Q2, hawkish rhetoric from Fed Chair Jerome Powell and other colleagues briefly revived US recession fears. Bond markets fell nearly 1% amid a re-steepening in the yield curve, with the spread between 2- and 10-Year Treasuries widening to -106. The jitters were not limited to the US: in the Euro area, the benchmark German yield curve inverted to its steepest levels since 1992.

The widely hoped-for soft landing for the US economy, which looked far-fetched a year ago, is now more firmly in the cards. That doesn't mean that investors can relax. Prices are still rising considerably faster than the Fed's 2% target for price stability. On the positive side, there were more convincing signs in Q2 that underlying inflation is decelerating, while still above the headline rate which fell to 3% in June, pulled down by falling energy prices. But the Fed, along with other major central banks, likely has further to go in the tightening cycle. In Q2, the Fed consensus view of the funds-rate peak went up to 5.6%, implying two more hikes of 25 basis points. Two further increases would dampen spending in the second half of this year. Cautious banks were already curbing business lending in the first half of this year. Further rate rises will exacerbate that trend.

Figure 1. A resilient US economy pushes down the probability of a recession within the next year



Note: Forecasts for 12 months ahead. Goldman Sachs started tracking probabilities in April 2022. FRBNY calculates their probabilities using the term spread for the 10-year and 3-month Treasury rates while Bloomberg estimates the median probability from a survey of economists.

Source: Bloomberg Finance LP, Goldman Sachs Global Investment Research, Federal Reserve Bank of New York.

THREE THEMES TO WATCH IN Q3:

01 PEAKING INTEREST RATES

The post-pandemic tightening cycle that began in 2022 is almost over. The third quarter will likely see the last rate hike from the Fed, either in July or September. Will markets cheer, or have the equities gains already been booked? That could depend on whether rates are set to stay high for longer.

02 INFLATION, INFLATION, INFLATION

Opinion is divided about whether the global monetary tightening that has already happened will be enough to cool demand and inflation. If underlying price increases stay in the 4% range, policy will stay tight until something gives. With luck, the Q2 disinflation trend will continue.

03 THE LANDING: HARD OR SOFT?

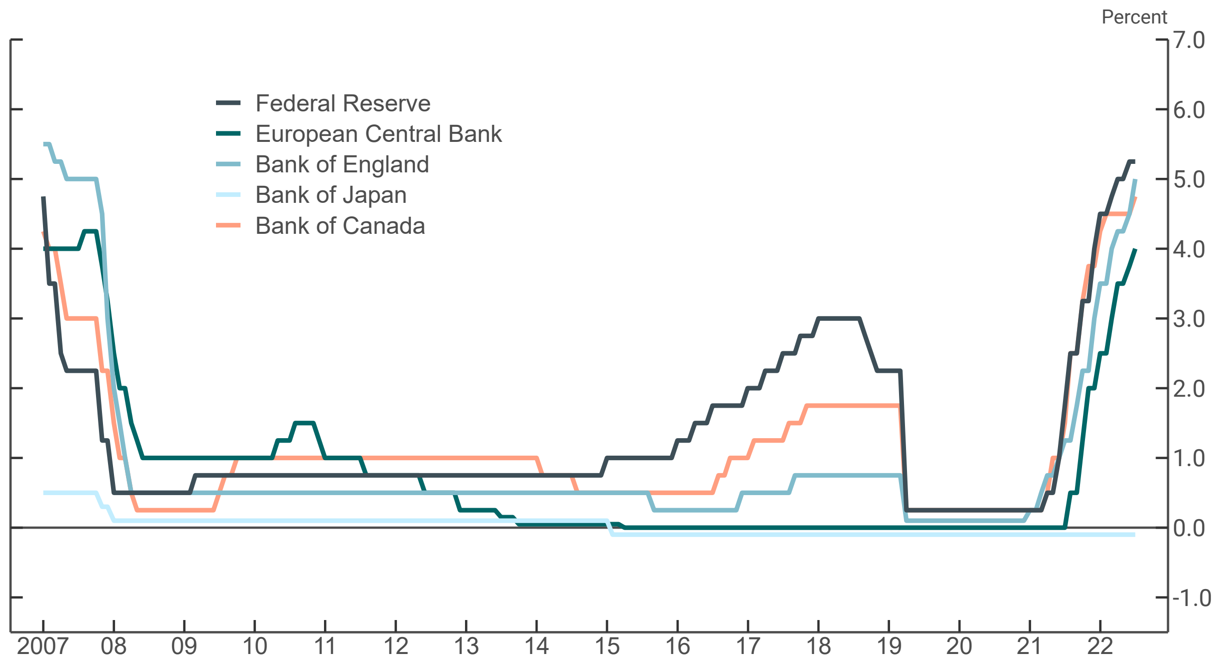
Europe likely slipped into recession over the end of 2022/23. Can the US avoid it? Will regional bank problems resurface, curbing credit?

The bottom line? A US recession is still possible. But developments in Q2 raised the odds that the US can escape without one this year or next. For institutional investors, a diversified portfolio has been the best way to navigate the last year of switchback turns and data revisions. It continues to be the strongest defense in times of uncertainty. Changing macro conditions have provided more interesting opportunities in fixed income than have been evident over the last decade of “low for longer” interest rates. More broadly, investment opportunities outside of traditional public equities and fixed income were plentiful in Q2.

MOVING CLOSER TO BALANCE

Fears that the fight against inflation would inevitably trigger recession – and a sharp rise in unemployment – have not played out so far, at least not in the US. In Europe, also, the hit to activity has been more contained than was feared when energy shortages first appeared in the wake of Russia’s invasion of Ukraine. Inflation is coming down. And the trade-off between the need to curb inflation and the risk of over tightening has shifted. Inflation is off its peak on both sides of the Atlantic.

Figure 2. Central Banks' policy rates may be hitting their peak



Source: Federal Reserve Board, European Central Bank, Bank of England, Bank of Japan via Bloomberg Finance LP.

Against this backdrop, the Fed is not the only central bank moving close to the end of the tightening cycle and taking a pause to consider how much further to go. Canada took a four-month pause, which ended in June. Australia hiked in June, against market expectations, but then paused in early July. Policymakers are reassessing the balance between underlying inflation and slowing growth – or supply and demand. India – still small in relation to the global economy, but now the fastest-growing as well as the most populous country in the world – held rates at 6.5% in Q2, against some expectations. As inflation nudged down in May, the RBI's hawkishness looked like a good call.

In Europe and the UK, central banks facing more substantial and stubborn inflation continued to hike policy rates at every meeting last quarter. The Bank of England pushed rates up by another 50 basis points in June after disappointing inflation data, bringing its rate to 5%, while the European Central Bank's June move of 25 basis points took its benchmark deposit rate to 3.5%, the highest in more than 20 years.

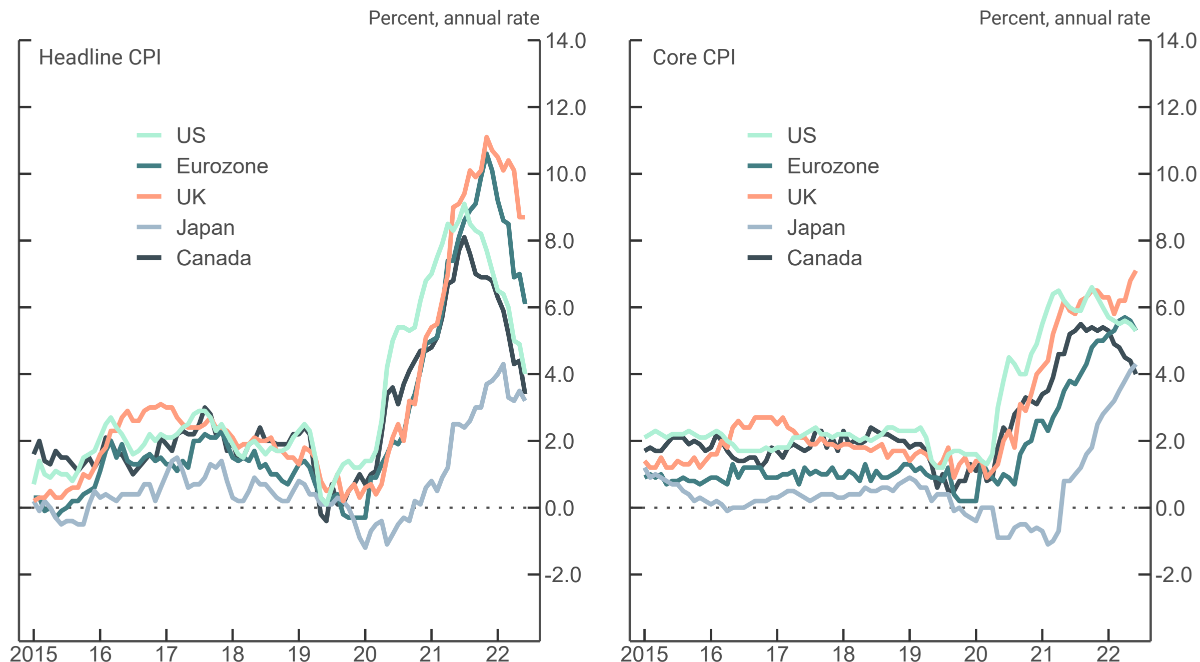
Japan – long wrestling with deflation – has sat out the tightening cycle and held monetary policy unchanged in Q2 under new Governor Kazuo Ueda. However, market pressure to let rates rise — coupled with accumulating evidence that the country's three-decade deflation may finally be over (long-term business inflation expectations now sit around 2%) — is likely to lead to a relaxation of yield curve control (YCC) in the coming months. The JPY remains a strong recession hedge, but future rate hikes could affect its status as a safe haven for international investors.

THE INFLATION BEAST IS WEAKER, BUT NOT YET VANQUISHED

For much of Q2, price watchers were disappointed. While headline inflation continued to drift down in many countries, underlying – or core – Inflation remained sticky. ECB President Christine Lagarde warned in June that the Bank expected inflation "to remain too high for too long".

The Bank for International Settlements (BIS), often seen as the central banks' central bank, took a similarly downbeat view in its Annual Report, cautioning that price increases of more than 60% of the items in the average consumer basket were running at more than 5% yearly. The BIS blamed

Figure 3. Too high for too long: the trouble with sticky inflation



Source: Consumer price indexes, US Bureau of Labor Statistics, Eurostat, UK Office of National Statistics, Statistique Canada, and Japan Ministry of Internal Affairs and Communications via Bloomberg LP.

monetary and fiscal stimulus packages in the pandemic that were “too large, too broad and too long-lasting” and called for more restrictive policies. They noted that with tight labor markets it would be understandable if workers tried to make up for the real wage losses experienced during the recent inflationary surge.

Labor markets remained strong in the US in Q2, although there were some signs of a loosening during the period. After climbing in April, job openings fell in May to a lower-than-expected 9.8 million, marking the first time since 2021 that total openings fell below 10 million, and bringing the number of vacancies per unemployed person down significantly from the peak of more than two to one in 2022. Employment gains continued apace. In June, nonfarm payrolls added 209,000 and unemployment ticked down to 3.6%. The payrolls increase was below expectations for the first time in 15 months and the smallest since 2020. But the average monthly increase during Q2 of 244,000 is still above pre-pandemic averages.

The churn in the labor market caused by the pandemic has also had potential upsides, including more competitive labor markets and partially reversed wage inequality. A recent paper by economist David Autor, of “China Shock” fame, estimated that bigger wage increases for younger, non-college educated workers since the pandemic had, by the end of 2022, eliminated a quarter of the rise in inequality built up over the preceding 40 years. Post-pandemic wage gains have continued to favor the lower paid, largely reflecting moves up the job ladder as workers who lost jobs in the early pandemic period were hired into better paying positions during the recovery. Growth remained strong in June, with average hourly earnings growing 4.4% year-over-year. The BIS is, nevertheless, correct that a broader catch-up in real wages, unless absorbed into profit margins, would keep inflation uncomfortably high. Many economists fear that outcome. IMF First Deputy Managing Director Gita Gopinath called attention in June to “three uncomfortable truths,” warning that “inflation remains sticky; financial stresses could make price and financial stability a difficult balancing act; and more upside inflation risks are likely.

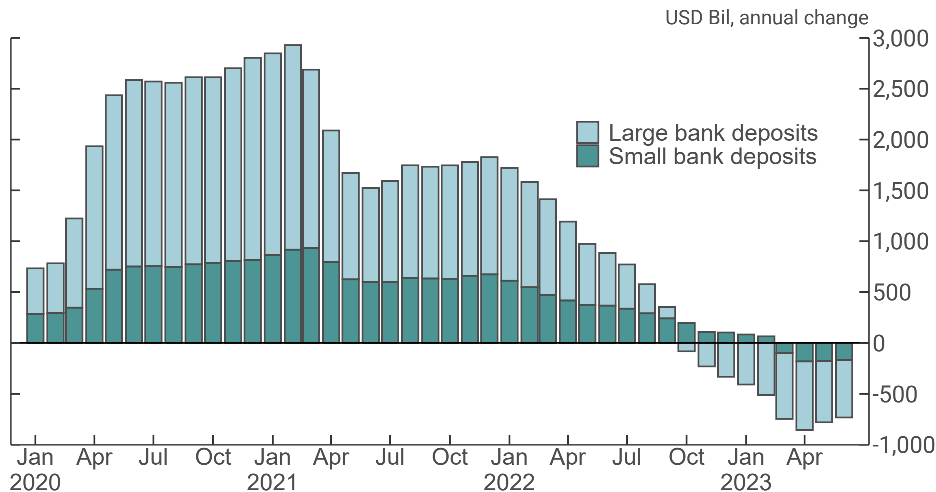
Regardless, there were some cheering signs in the Q2 price data for the US. The Fed’s preferred inflation measure – derived from personal consumption data that put a lesser weight on housing than the CPI – eased during the quarter. By May, various metrics based on this indicator – looked at over different time periods and adjusted for volatile prices in different ways – showed inflation running at an annual rate somewhere between 2.5% and 4.1%. The June information for PCE inflation is not yet available. But good news came in the CPI and the producer price indices for June. The headline CPI was up 4% over a year earlier in Q2, with a clear slowdown during the quarter to 3% by June. And the change from Q1 was just 2.2% at an annualized rate.

BOX 1. REGIONAL BANK DEVELOPMENTS

The US banking system continued to feel the mild tremors from market turmoil that began in the first quarter with the collapse of Silicon Valley Bank (SVB) and Signature Bank. In April, despite efforts from eleven major banks to assuage fears by injecting $30 billion in deposits, San Francisco-based First Republic also fell victim to a run by uninsured depositors. Several more regional banks have since experienced severe pressure.

There are signs that things are stabilizing, but regional lenders will face an uphill battle as higher rates and the liquidity crunch will put further pressure on margins. While these lenders saw some reprieve after the Fed's June stress test showed midsized lenders maintained capital levels above required levels, the KBW Regional Bank Index plunged 6.7% over Q2, reaching a YTD loss of 22%.

Figure 1.1 Banks deposit outflows continue at a steady pace



Source: Federal Reserve Board, Statistical Release H.8, "Assets and Liabilities of Commercial Banks in the United States (Weekly)."

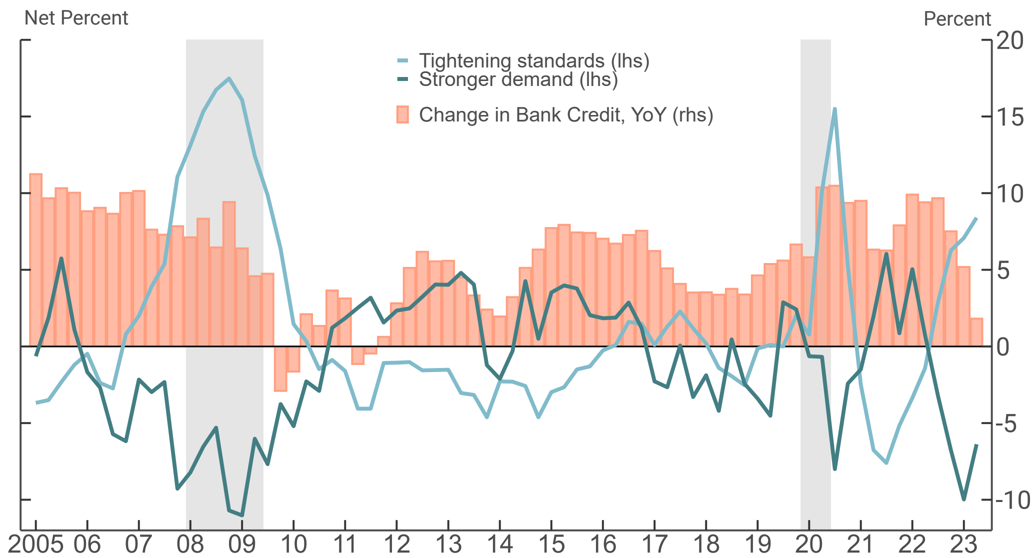
Even as the dust settles from the recent government interventions, these lenders face underlying problems. Banks were already experiencing deposit outflows late last year as depositors searched for higher yields. The events in March merely accelerated the trend. They are also tightening credit standards and borrower demand is waning as funding costs grow. At the same time, rising rates are deepening losses on banks' balance sheets, raising concerns that banks will need to sell assets at a loss to cover the heightened demand for cash. Losses on the loan book are beginning to manifest, particularly on the commercial real estate side, where banks represent nearly 70% of total CRE loans outstanding. They also represent a much higher proportion of regional banking balance sheets, with more than over 40% of total assets in CRE loans.

The landscape for regional banks is poised to undergo a major shift. To overcome the rising costs associated with higher rates and potential new regulatory requirements, these banks will need to

BOX 1 — *continued*

get bigger, making consolidation the most attractive option for these lenders. Merger activity has reached its lowest levels in over a decade, but the recent shakeup will likely lead to a new wave of consolidation. The actual merger process will take some time to play out, but investors see several opportunities in the financials space as bigger banks look to snap up distressed assets at attractive prices and smaller banks restructure.

Figure 1.2 Credit standards are tightening and demand is weakening



Source: Federal Reserve Board, Statistical Release H.8, "Assets and Liabilities of Commercial Banks in the United States (Weekly)"; and Senior Loan Oficer Opinion Survey (SLOOS).

POST-PANDEMIC STRENGTH RESTS ON THE CONSUMER: AMERICANS ARE CHAMPION SPENDERS

Consumer resilience and a strong labor market continued to buoy the US economy in Q2. Recently revised data show that growth was stronger in Q1 than first reported, at an annual rate of 2%. The driver was consumption.

There was some evidence towards the end of Q2 that the long-expected drop off in demand, as higher interest rates feed into the economy and pandemic savings are depleted, may now be underway, but at a gentle pace. Retail sales in June grew by just 0.2% from May, less than expected but still in positive territory. Looking ahead, the cancellation of federal student debt relief in September following the Supreme Court decision in June will also depress some consumer spending and demand. However, barring a resurgence of bank weakness that cripples credit (see Box 1), the US economy is likely to eke out growth in the months ahead.

The picture is not as hopeful in most other major economies. In Europe, the economy already contracted over the turn of the year and stagnated or shrank further in Q2 as rate hikes continued. Europe's energy dependence on Russia made the supply shock from the war in Ukraine and resulting sanctions more costly, although less so than dire warnings from German industrialists had earlier suggested. Growing US tensions with China have also affected confidence in Europe's export machine, particularly in the bigger economies. Disaffection with an anemic economy is a major factor in the pension-reform protests and rioting sparked by police brutality that rocked France in late June.

In China, growth continues but at a more disappointing pace than expected when zero-Covid policies were relaxed at the start of the year. Beijing turned to a familiar playbook to boost growth in Q2, lowering interest rates and easing regulations to boost investment, particularly in the all-important property sector. Absent a fiscal stimulus, however, the consensus is that this alone is unlikely to unlock the domestic consumption needed to push up the growth rate. And continued geopolitical tensions are having a dampening effect. Planned US controls on outward investment to China are adding to private company concerns of over dependence on Chinese markets and Chinese suppliers. Chinese companies are, themselves, investing more outside of China.

GLOBALIZATION IN RETREAT: DE-RISKING VERSUS DE-COUPLING VERSUS DIVERSIFYING

Geopolitical risks remained high in Q2. In recognition of the deep economic and financial ties between China and the rest of the world, the US and Europe shifted to softer language in describing their goals in relation to China. Instead of "decoupling", an unrealistic and costly aim, "de-risking" is favored. In a delayed trip to China that finally happened shortly after Q2 closed, Treasury Secretary Janet Yellen took the "d-words" a step further. "There is an important distinction between decoupling, on the one hand, and on the other hand, diversifying critical supply chains or taking targeted national security actions," Secretary Yellen said. "We want a dynamic and healthy global economy that is open, free, and fair – not one that is fragmented or forces countries to take sides." That means nations should avoid over-dependence on Chinese inputs for essential technology and products while also reducing the supply of key advanced technology that could be used for military purposes. The federal government has recognized the challenge of defining the latter, given the expanse of dual use technology, as it simultaneously seeks to rebalance its CFIUS and Entity List standards while resolving perspective differences with long-time partners like France.

American policy in this area is still finding its way. National Security Adviser Jake Sullivan laid out expansive goals in an April speech for a new Washington consensus based on industrial policy and subsidies to critical investments. The US also succeeded in winning broader G7 support for a stern message to China. Further, despite pushing back fiercely, China followed through on US overtures to restart high-ranking visits to Beijing after the February downing of a "red spy balloon" led Secretary of State Antony Blinken to cancel a planned trip.

Secretary Blinken's visit in June was half successful. He met with President Xi Jinping, in a rare display of high-level engagement. But China refused the main ask from the US: an agreement on emergency communication channels between the two governments and their militaries akin to the Cold War Red Line with Moscow that could be used to avert accidental crises. China prefers to keep the US off-balance, and regards strategic ambiguity as vital leverage. Importantly for investors, the US continues to work towards limits on outward investment to China, in coordination with allies and partners. Delays reflect the difficulty in defining what is defense-

sensitive in a way that does not overly constrict exports or investments, potentially backfire on US companies, or those of the allies and partners.

War in Europe continues unabated, with the long-awaited Ukraine counteroffensive making slow progress against dug-in Russian troops. The world was given a brief window into the political difficulties for Russian President Putin with a 36-hour mutiny by former ally and ringleader of the Wagner mercenary group Yevgeny Prigozhin which showed that the next Russian leader could be even more unpalatable to the US. More importantly than the short-lived rebellion in Russia, the head of the CIA, career diplomat William Burns, took an unannounced trip to Kyiv to discuss prospects of peace with President Zelenskyy. This is still some way off.

The war and other supply chain concerns are impacting the defense industry, which accounts for 3.0% of the US economy. The Institute for International Strategic Studies (IISS) noted in a recent blog that perhaps “just-in-time” is now more appropriately termed as “just too late. ” The defense industry is now undergoing the biggest shift in organization since the end of the Cold War, IISS noted, when the prospect of peace led to a dramatic downsizing in spending. This time of course, governments are ramping up demand- Lockheed Martin alone saw order backlogs grow to an unprecedented $158 billion in June.