Aegon Asset Management

THE US MACRO WEEK THAT WAS

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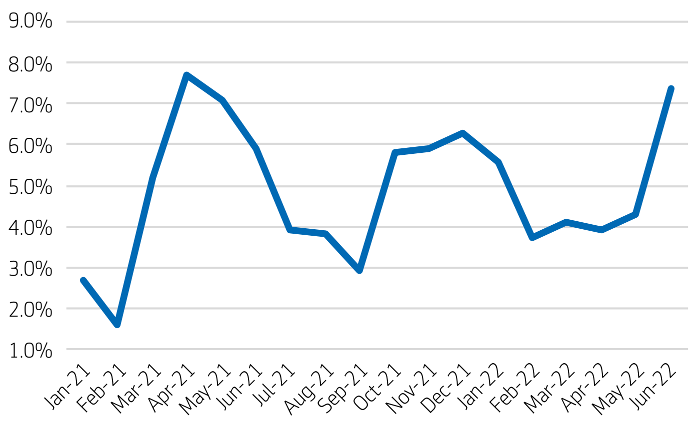
We continue to be more bearish than the consensus and expect growth will be well below trend in all major regions next year as a result of restrictive monetary policy taking effect.

	2021 Actual	2022 Forecast		2023 Forecast	
GDP growth		Consensus	Aegon	Consensus	Aegon
US	5.7	2.0	1.5	1.3	0.8
Eurozone	5.2	2.7	2.1	1.1	1.0
UK	7.2	3.4	3.0	0.6	0.0
Japan	1.7	1.6	2.0	1.7	1.2
China	8.1	4.0	4.0	5.2	5.2

Frankly, we are quite astounded by the market's emerging narrative that Federal Reserve Chairman Jerome Powell made a dovish pivot on Wednesday, July 27, 2022. It seems they are confusing a sentiment-fueled bear market rally with a perceived telegraphing of a policy change. To the latter, we saw nothing of the sort. Not only is the federal funds rate likely going another 100 basis points higher from here (as both Aegon Asset Management and the markets have forecast), but Powell's rhetoric was very focused on fighting inflation at the expense of growth. Merge that with a core PCE that came out Friday, July 29 showing an acceleration in core inflation, and we believe a true pivot may be a wee bit off. Rather, our base case is still a 3.5% fed funds rate by year end. But it will take time to get inflation down below 2.5%, which means the actual pivot to a rate cut is unlikely until next summer at the earliest.

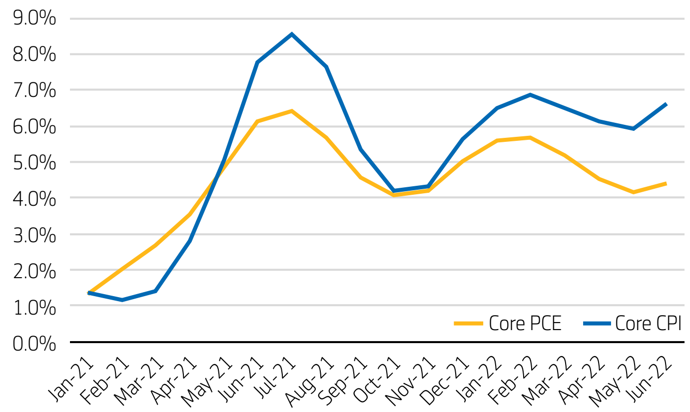
For a Fed "strongly committed to returning inflation to 2% objective," inflation momentum is going the wrong way for a dovish pivot, as the charts on this page show.

Exhibit 1: Core PCE - 1m AR



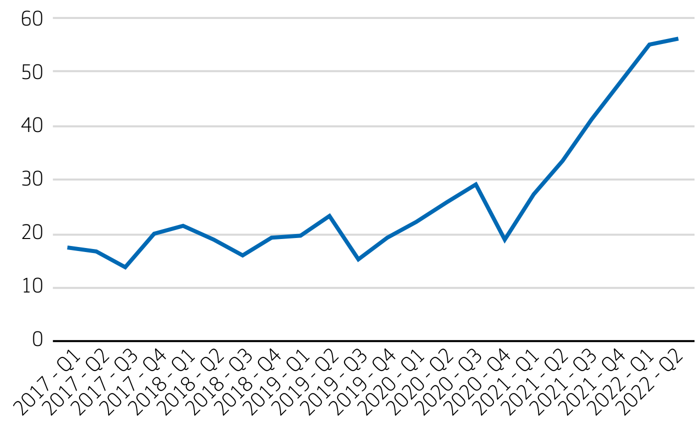
Sources: Bureau of Labor Statistics, Haver Analytics

Exhibit 2: Core inflation momentum—3-month annualized rates



Sources: Bureau of Labor Statistics, Haver Analytics

Exhibit 3: Dallas Fed trim mean: Percentage items with price growth > 5% annualized



Sources: Dallas Federal Reserve, Haver Analytics

As for recession, despite the technical definition being met (two consecutive quarters of GDP contraction), we believe that the US is not currently in a recession … yet. We also note that without the massive pandemic-related inventory swing, GDP would likely have been +1.1%. Plus, the labor market, while slowing, still grew at +3.5% annualized pace in the second quarter—definitely not recessionary.

However, we still think a recession is very likely next year under the current path of policy. Private domestic demand (86% of the economy) is rapidly slowing, combine that with real disposable incomes falling for five straight quarters and you have a recipe for demand destruction (which is what Powell is hoping for to bring down inflation).

Here is the worst-case scenario for the Fed: If an actual recession/anemic growth occurs, but inflation is stubborn in coming down. This is the scenario that the market isn't thinking about at all and would require a substantial repricing of risk assets.

We continue to believe that markets (especially equities) have priced a slowdown, but not a recession. There has never been a recession where corporate earnings haven't contracted, yet earnings are forecasted to accelerate from here into a 9% year-over-year rate in 2023 and multiples are at average levels.

Furthermore, the strong revenue gains companies are reporting for the second quarter are directly correlated to the strong nominal GDP growth (while real GDP was at a -0.9% annualized rate, nominal GDP was at a +7.8% annualized rate). But that is mostly price related, not unit growth and thus aggregate margins peaked in the third quarter of 2021. We continue to like 10-year Treasuries above 3%, though are not too excited down here at 2.6%. Typically, this late in the cycle is not good for assets, so we still favor up in quality for now. We expect there will come a time to overload risk for the strategic horizon, but now is too soon.

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