BERNSTEIN

It's Getting Hot in Here

After a rough start to the year in terms of the macroeconomic and geopolitical backdrop, unfortunately, the situation has not improved.

Thankfully, the strains of the coronavirus and associated lockdowns continue to ease as the virus becomes endemic. At the same time, inflationary pressures have grown more persistent, forcing a tightening of financial conditions. As a result, we have lowered our global growth outlook and increased the likelihood of recession.

Amid increasing economic risks and tighter financial conditions, market prices already reflect many of these concerns. The S&P 500 has been hovering right around the (20)% threshold—which defines a bear market—and the global MSCI ACWI IMI index is down (22)% from its November peak.

The More Things Change, The More They Stay the Same

Our previous letter included a framework for evaluating changes to the global economy across several fronts for the first three months of the year. Unfortunately, looking at that same list three months later, the negative trend has largely persisted. In the US and other developed markets, the focus has further shifted from inflation to growth pressures. China stands out as the lone area of improvement, as we're beginning to see more signs of normalization and an increased likelihood of supportive policy from the government.

Factor	End Q1	End Q2	Better/Worse
Inflation	High, centered in goods inflation, with near-term inflationary pressures, still expected to decline over time	High, centered in services inflation, some goods pressures fading organically. Even tighter financial conditions will be necessary	Worse
Growth	Above-trend and slowing	Slowing faster	Worse
Recession Risk in the US and Europe	1-in-3 or 1-in-4 chance of recession in US. 50-50 chance of recession in Europe	25% chance of bad recession and 50% chance of severe slowdown in US. Europe even worse	Worse
Emerging Markets	Risks from rising food/commodity costs and potential for political risk	Risks from rising food/commodity costs and potential for political risk	Same
China	Focus on response to Russian invasion. More macro uncertainty but potential for stimulus on horizon	Emerging from COVID-19 lockdowns. High likelihood of large fiscal stimulus in back half of 2022	Better

Where Do We Go from Here?

With elevated uncertainty across the economy and markets, we believe the current moment is especially well suited to weighing the range of scenarios we might face from here. We lay out our base case, bear case, and bull case below.

Our base case (50% probability) is that inflation begins to fall due to tighter financial conditions and easing pandemic-related supply constraints, but at the expense of economic growth, with US economic activity slowing toward 1%. Technically, the economy may slip into a "defined recession," but with growth as slow as we're forecasting, the distinction is irrelevant. With the Fed forced into an aggressive stance, interest rates may climb toward 4% (up from 3% today). Nominal earnings growth would slow due to lackluster economic activity—perhaps coming in flat year-over-year in 2023—and valuations would reset from levels north of 20x last year to closer to mid-teens, reflecting the subdued backdrop.

In our bear case (25% probability), the US economy would go into a clear and obvious recession between now and the end of 2023. This would most likely happen due to inflation pressures persisting, either forcing the Federal Reserve to over-tighten to sap demand or leading to a policy error. With limited excesses in the real economy to wring out, we expect such a recession would be relatively moderate, but it could stretch out if policymakers are shy to intervene.

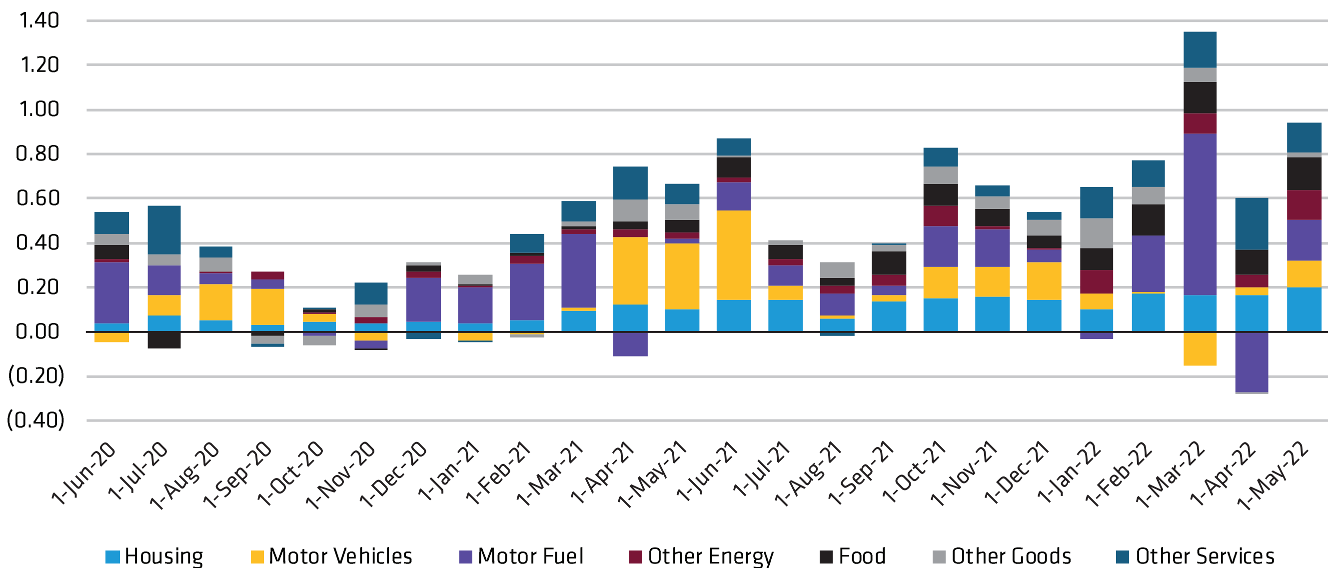
Our bull case (25% probability) would see inflation beginning to ease markedly in the coming months and thus allow rates to normalize near 3%. Economic growth would slow slightly, but not by enough to materially hurt expected earnings growth rates. Stock market multiples would benefit in two ways—first from a better interest rate backdrop and second from improving risk appetite.

Mile Markers Ahead

How will we know, as early as possible, which of these paths we're heading down? The most important data point we continue to watch is the monthly Consumer Price Inflation release (Display). We're particularly focused on the prices of services and goods which weren't subject to COVID-19-related shortages; that's where the impact of monetary policy should be seen most clearly. If price pressures in those categories begin to ease—aided by post-pandemic normalization in other categories—we'd find that encouraging. On the other hand, if those price pressures persist, the Fed may have to be more heavy-handed, meaning higher interest rates, lower growth, and more volatility for markets.

INFLATION IS OUR BEST INDICATOR FOR THE POLICY PATH

Contribution to Monthly Change in CPI



Source: Bureau of Labor Statistics, Bloomberg, and Bernstein analysis

Likewise, we're watching housing prices and the state of that market, because of their impact on economic growth and inflation. We have started to see softening here, as housing affordability has declined notably as mortgage rates have risen. Sometimes, what is "bad news" for consumers is "good news" for investors. With housing costs accounting for one-third of the consumer price basket, any drop in those prices will provide evidence to the Fed that its rate increases are working—easing the pressure to continue hiking rates going forward.

Cars, another key component of economic activity, have experienced some of the most vivid inflation this cycle. For that reason, we're watching for a combination of increased production capacity for new cars and falling prices for used cars. We're also closely monitoring monthly purchasing manager surveys, which track economic growth.

Interest rates are incredibly important—a point driven home by the markets this year. And, while they can be noisy, the bond markets give a constant appraisal of investors' beliefs about the future path of rates. To that end, we're checking the yield curve for any warnings of a recession or policy mistake. Currently, the bond markets are pricing in aggressive rate hikes through the end of the year and at this point, what looks like more of a soft landing than a Fed-induced recession over the balance of 2023.

While inflation could still conceivably spiral from here, we believe it is much more likely that it moderates in the coming quarters as post-pandemic supply chain constraints ease, inventories build, and global central banks' rate hikes pressure aggregate demand.

Get Through with a Long-Term View

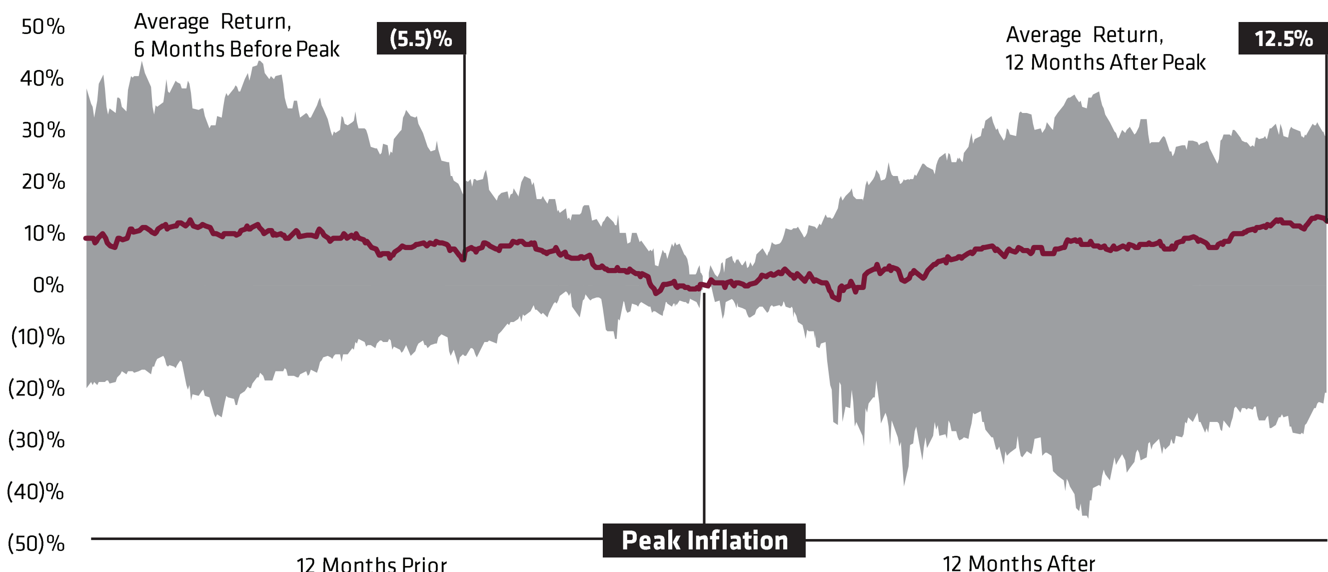
For opportunistic investors, there are some areas of interest—in public equities, quality growth appears to be on sale, especially in the technology sector. Furthermore, while hypergrowth tech had some froth coming into the year, there are likely some babies being thrown out with the bathwater for investors with a multi-decade horizon. Disruptive technologies are not going away, nor is innovation, yet valuations of disruptive companies have compressed meaningfully.

We've also been eyeing China for months, and our portfolio managers have been shifting allocations to increase exposure there recently. Finally, amid interest rate uncertainty, floating rate investments in private credit or commercial real estate debt still look attractive.

Our Investment Strategy Group and our portfolio managers continue to assess the economy on an ongoing basis to find the areas of the market that seem most disconnected from their fundamentals. Yet, the best strategy for our clients remains taking a long-term view—committing to your strategic asset allocation and diversifying across asset classes, geographies, and sectors. While we have an array of strategies that are helpful in mitigating risk, we still have not found any "free lunches" in these asset allocation trade-offs. Please thoroughly discuss any tactical or strategic allocation changes carefully with your advisor before pursuing them, as the market may just as easily rebound quickly once certainty emerges on the path forward.

EQUITIES HAVE HISTORICALLY RALLIED ONCE INFLATION PEAKS

S&P 500 Returns Indexed to Peak Inflation since 1950



As of June 30, 2022. **Historical analysis is not necessarily indicative of future results. There is no guarantee that any estimates or forecasts will be realized.** Inflation Peaking is defined as a peak in YoY Inflation of 5% or more. The following are peak years: 1951, 1970, 1974, 1980, 1990, 2008.
Source: Bloomberg, Bureau of Labor Statistics, and Bernstein analysis

On that note, the past two years have been marked by especially high uncertainty. But a long-term perspective and ongoing participation in the markets and in the productive assets of the global economy have served our clients well since the end of 2019 and in the years and decades prior. We expect them to serve our clients in the coming years and decades as well.

Despite the market turmoil, we hope you are enjoying the summer months.

Best,

Beata & Alex

Alex Chaloff

Beata Kirr

Alex Chaloff and Beata Kirr are Co-heads of the Investment Strategy team at Bernstein, a group of senior investment professionals who develop our investment advice and are responsible for investment outcomes. The team oversees Bernstein's investment offerings, ensuring that our asset allocation advice, suite of strategies, and development of new investment ideas are continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Both Alex and Beata have spent their Bernstein careers refining our investment platform, listening to clients, and conducting deep research into investment topics that are critical to achieving clients' goals.

Bernstein does not provide tax, legal, or accounting advice. This document is for informational purposes only and does not constitute investment advice. There is no guarantee that any projection, forecast, or opinion in this material will be realized. The views expressed herein may change at any time after the date of this publication.

The [A/B] logo is a registered service mark of AllianceBernstein, and AllianceBernstein® is a registered service mark, used by permission of the owner, AllianceBernstein L.P., 501 Commerce Street, Nashville, TN 37203.

© 2022 AllianceBernstein L.P.