The Rule of Three: Inflation, Recession, Growth

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The number *three* is pervasive through some of society's greatest stories—there were three little pigs, three musketeers, and three stooges, for example. In fact, the use of the number three in storytelling is so common that it's come to be known as the rule of three.

In keeping with that concept, here are my big three for investors to consider in the fourth quarter of 2022: recessionary fears, high inflation, and slowing growth.

The economic outlook appears particularly challenged in all three of the world's principal demand centers (United States, Europe, and China) over the next six months. The U.S. economy is balanced precariously between peaking inflation and a determined U.S. Federal Reserve (Fed); Europe faces significant energy-price shock from the ongoing Russian invasion of Ukraine; and Chinese consumers are much more challenged than is generally appreciated due to the resurgence of COVID cases.

Recession

As we analyze the risk of recession in the United States, we must consider whether the country can shift into a more normal expansion, growing at its pre-COVID average, or whether the consumer is more likely to hit the spending breaks, sending the economy into a recession.

The answer, we believe, will depend on how quickly inflationary pressures abate and the Fed can reach its approximate target policy rate. With key indicators such as the labor market (essentially, wages and payroll) yet to

see a significant slowdown, it is likely that chances of a pivot to a less hawkish stance will remain low for the remainder of the year.

In Europe, recession appears unavoidable. Simply put, Europe has been hit with a sudden and large energy shock. This is not so much about whether Europe will have enough gas to heat its homes this coming winter, but rather about its energy prices being multiples higher moving forward. This has become an increasing concern as both Nord Stream pipelines were discovered to have multiple leaks.

In addition, while China appears particularly challenged due to ongoing COVID-related disruptions of its domestic economy, demand recovery is expected as its zero-COVID policy eases. This could begin as early as spring 2023. Early signs of gradual easing of monetary policy and increased fiscal stimulus are also supportive to recovery of growth.

Inflation

Global inflation rates have continued to soar in 2022. As we discussed last quarter, inflation has been significantly influenced by Russia's invasion of Ukraine.

As a result, Europe is only now reaching its pre-COVID output trajectory, which is considerably slower than that of the United States. Inflation is also high in Europe, with high energy prices (the result of substituting liquified natural gas, or LNG, for Russian gas) driving inflation. We expect European inflation to peak when energy prices roll over.

In the United States, slowing consumer demand and normalizing supply chains are beginning to exert downward pressure on inflation. Specifically, goods price inflation has already rolled over, although it will be many more months before the year-over-year print will be at 2%. Monthly consumer price index (CPI) data will remain a key indicator to monitor as we look to determine when annual inflation will decelerate closer to its target range.

Growth

Corporate earnings growth, especially outside the United States, is widely expected to decelerate throughout the remainder of 2022, given the soaring inflation and macroeconomic uncertainty. While some of that expected deceleration has been reflected in multiple contraction, we expect negative earnings revisions to continue to put further downward pressure on multiples.

One More: The Dollar

Lastly, we cannot have a discussion on the economic outlook without mentioning the wild moves in U.S. dollar exchange rates this year.

Europe's massive energy-price shock and inflationary pressures have created large currency discrepancies. With the U.S. dollar the strongest it has been since the mid-1980s, the message from the foreign exchange markets seemingly is that the U.S. economy is the most resilient in the face of current economic headwinds.

What could break the upward trend of the U.S. dollar? We believe the likely scenario would require either an easing of natural gas prices in Europe, which are up nearly tenfold in a 12-month period, or the Fed's hawkish monetary policy tightening to push the United States into a recession (which would ultimately put downward pressure on the U.S. dollar).

Investment Implications

As we continue to analyze various market outcomes while uncertainty remains quite high, we increasingly believe that the underlying corporate performance of our portfolio holdings is quite resilient, and their long-term earnings power is likely to remain unchanged. Looking forward, we believe equity returns will likely be driven by earnings growth, and multiple compression will largely stop when earnings growth ceases to decelerate.

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