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BIL Midyear Outlook 2023

THE LANDING PROCESS

Introduction from our Group Chief Investment Officer, Lionel De Broux

Our 2023 Investment Outlook, published back in December, was entitled “Preparing for landing”. As central banks tighten monetary policy to bring down inflation, the key question is whether they will be able to achieve a soft landing for their respective economies in the form of a mild recession, no major spike in unemployment and just enough demand destruction to curb inflation.

Standing at the midpoint of 2023, the landing process has begun, most notably in the US where we expect a mild recession later this year. Europe’s economy has received some tailwinds from fiscal support, the avoidance of an energy crisis and supply chain improvements, but this has not been enough to prop up its manufacturing sector. As a result, we are seeing strong heterogeneity across countries, with Germany already in recession while economies that rely more on services are in better shape. Later in the year, Europe may receive a helping hand from China – if and when its reopening fully materialises – given that this is one of its key export destinations. Indeed, China offers a glimmer of hope for the world economy in that it is an outlier in the global tightening cycle. Moreover, its economic take-off following the end of zero-Covid policies could just be getting underway at a time when momentum is flagging elsewhere amid tighter financial conditions.

At present, taking an aerial view of the investment landscape leaves a conflicting picture that is frustrating for bears and bulls alike. Headline inflation is cooling, but the majority of developed market central banks are grappling with a shared problem: core inflation is proving stickier than expected and remains well above their 2% targets. Growth is clearly in descent from post pandemic highs but labour markets are extremely tight and consumer spending has remained relatively resilient. Corporate earnings are coming in above expectations but falling from an absolute perspective, and fear about the remainder of the year dominates. Banking turmoil –

which resulted in the collapse of three high-profile financial institutions – has stabilised, but we are nearing the end of central bank hiking cycles and tighter credit conditions are starting to bite. We will only know if they have tightened too much after the fact.

Markets are struggling to decide whether the glass is half full or half empty. They keep falling back into the habit of assuming that market stress or rising recessionary risk will compel the Fed and other central banks to start cutting rates soon, only for a strong datapoint to make them second guess themselves. Central banks, on the other hand, are still assessing whether rates will need to stay higher for longer, cognisant that they cannot yet declare victory in their battle against inflation. If market optimism about rate cuts is left to flourish, it could cause financial conditions to loosen, undoing some of their progress on fighting inflation so far. Moreover, policymakers are eager to avoid a repeat of the 1970s when stop-and-go Fed policies resulted in an inflationary spiral that took years to stub out (Appendix 1.1).

The fact that the market-implied policy pathway still diverges from that which policymakers have laid out in their forward guidance leaves room for disappointment and financial market volatility. This, alongside dimming global growth prospects and a lack of certainty as to whether the landing will be soft or hard, is determining our defensive portfolio positioning as we move into the second half of the year

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