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SECOR Asset Management

Quarterly Macroeconomic Outlook Update

April 29, 2022

Global Cyclical (2022-23) Outlook Revised Significantly Since January

- **Global Economy, Particularly Developed Markets ("DM"), Seemingly on Path to Normalization at Start of Year**
  - Above-trend DM growth expected in '22, albeit moderating from exceptional '21 pace
  - Pandemic-related inflation distortions expected to gradually unwind by YE '23

- **Invasion of Ukraine/ Higher-Than-Expected Core Inflation / China's Shutdowns Requiring Forecasters to …**
  - Lower growth & raise inflation outlooks: e.g., '22 changes: Global GDP -0.8%-pt., CPI +1.8%-pt. DM.+2.8%-pt. Emerging Markets ("EM")
  - Our baseline forecast still calls for avoiding recession over '22-'23 period
    - But latest inflationary surge has raised bar for achieving a soft landing

Expected Real GDP (%)*			
	Global	DM	EM
2021	6.2	5.2	7.1
2022	~~4.6~~ 3.4	~~4.0~~ 3.1	~~4.7~~ 3.6
2023	~~3.6~~ 3.4	~~2.5~~ 2.3	~~4.4~~ 4.2

Expected CPI (%)*		
Global	DM	EM
3.5	3.2	3.8
7.2	~~3.9~~ 5.7	~~5.9~~ 8.7
4.5	~~2.1~~ 2.5	~~4.7~~ 6.5

*GDP forecasts: SECOR; CPI forecasts: IMF; crossed-out forecasts are January 2022 forecasts

Selected DMs: US, Euro Area, and UK Cyclical Outlooks ('22-'23)

- **GDP: Continuing Expansion Expected With Important Nuances in Baseline Outlooks**
  - All are expected to benefit from limited scarring from pandemic recession
    - Strong financial positions, robust labor markets, stimulative policies, albeit less than in '21
  - Euro area most exposed to Russia, particularly for natural gas supplies
- **Inflation: Expected to Remain Above Central Banks' 2% Target in '22 and in '23 (ex EA)**
  - Inflation broadening beyond energy and food, particularly in the US and UK
    - Core inflation also above target in '22 and in '23 (ex EA)

Expected GDP (%)			
	'21	'22	'23
US	5.7	~~4.0~~ 3.5	~~2.5~~ 2.1
EA	5.3	~~4.2~~ 2.5	~~2.9~~ 2.3
UK	7.4	~~4.5~~ 3.8	~~2.5~~ 1.2

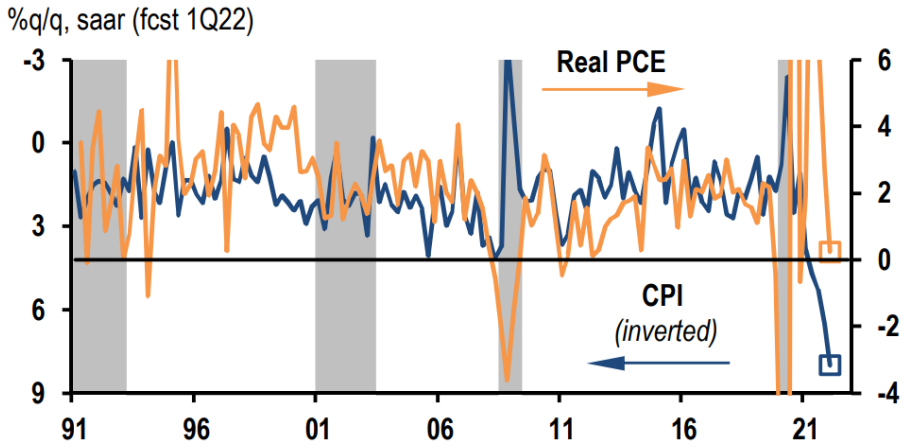
Expected Headline Inflation (%)		
'21	'22	'23
4.7	~~2.7~~ 4.3	~~2.3~~ 2.7
2.6	~~3.2~~ 5.1	~~1.9~~ 2.1
2.6	~~3.4~~ 7.1	~~2.8~~ 3.0

Expected Core Inflation (%)		
'21	'22	'23
3.6	4.1	2.6
1.5	2.9	2.0
2.4	4.6	2.5

*US: Fed's March median PCE projections; ECB's March HICP projections, UK: '22 April CE projections, '23 interpretation of MPC's February forecast

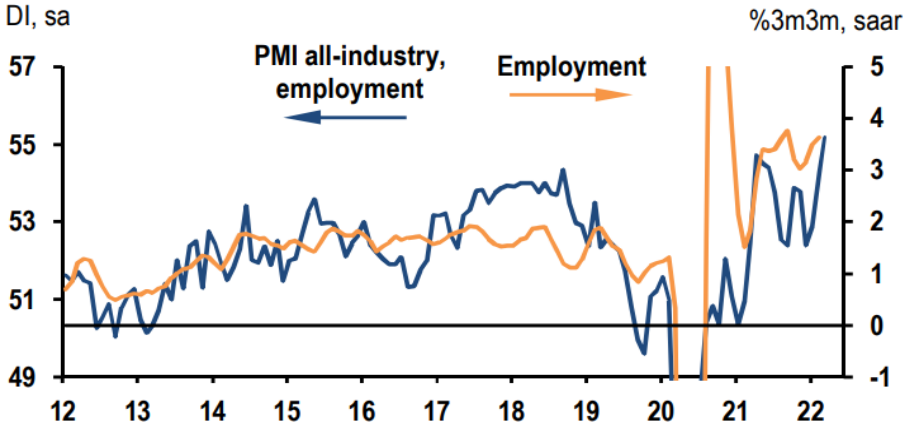
Underpinnings of DM Outlook: Despite Strong Headwinds Consumers Well Positioned

DM Consumer Spending Inflation



- DM consumers are facing strong headwinds from the most rapid rate of inflation since the early 1980s and…
- One-year ahead DM policy and mortgage rates are forecast at 200 bps. above current levels

Employment Robust



- Consumers, however, have considerable supports…
- DM employment expanded at 3.5% rate over past 3 quarters
- Unemployment at historic low, nominal wages are rising at rapid pace and…

Source: JPM, IHS/Market, JPM

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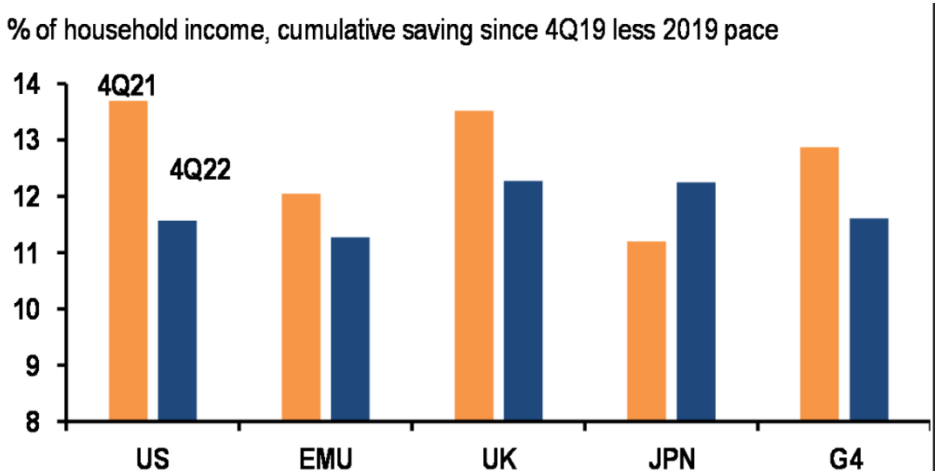
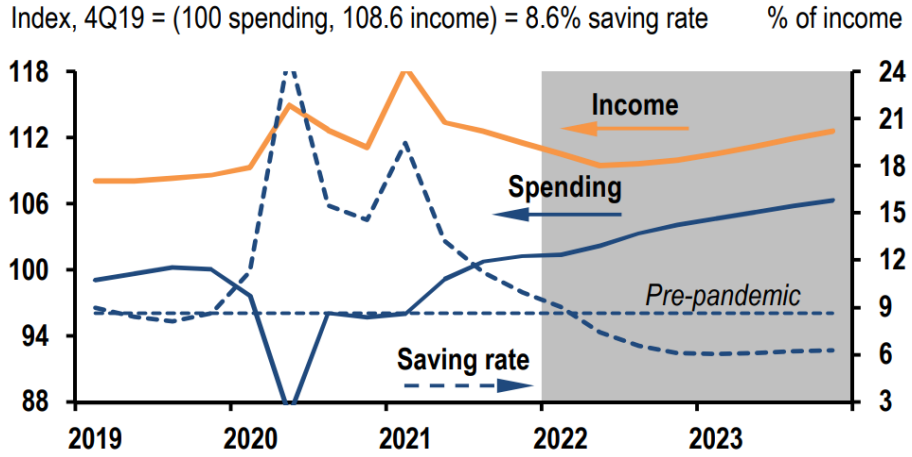
Underpinnings of DM Outlook: Despite Strong Headwinds Consumers Well Positioned-cont'd

Stock of Excess G4 Saving



- Consumers have accumulated unprecedented saving over the past two years
- At YE '21, G4 excess savings relative to pre-pandemic norms were equivalent to 13% of household income
- Balance sheets strong

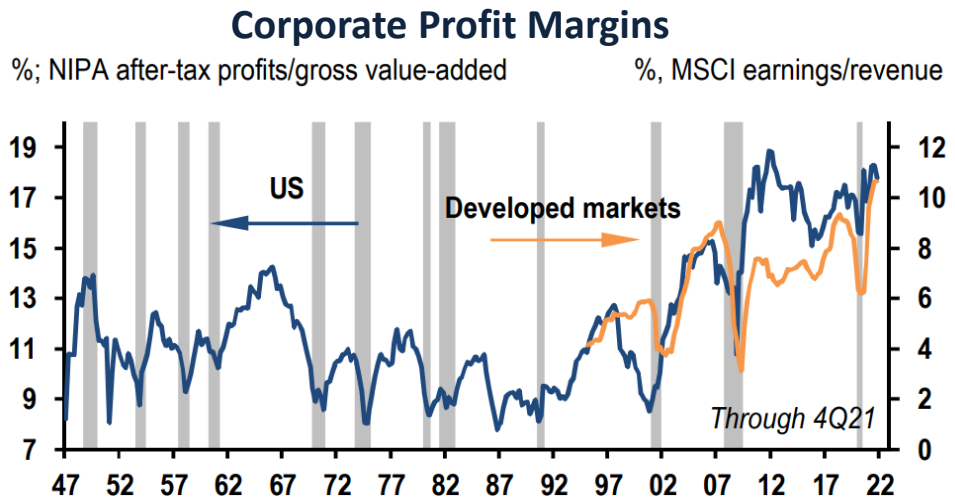
Household Income, Spending, Saving: GS

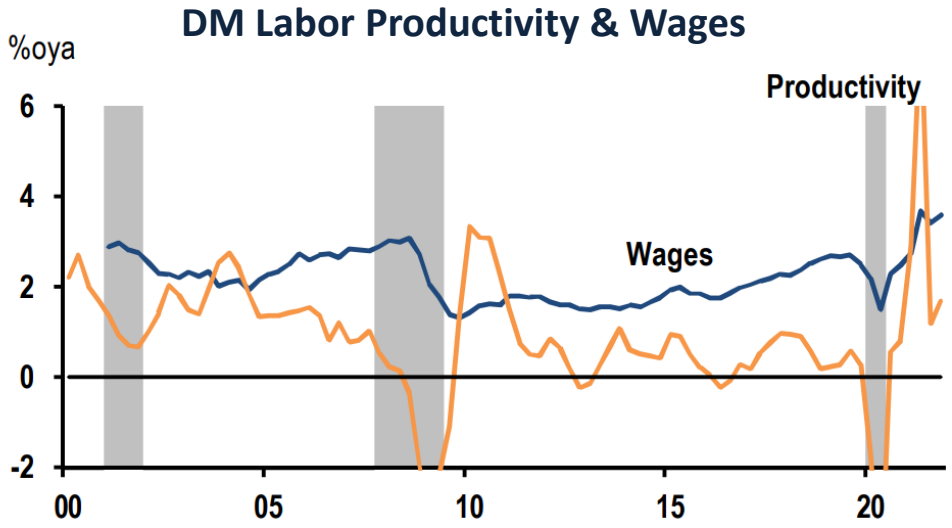


- Consumers expected to increase their spending over the '22-'23 cyclical horizon, albeit at a slower pace than in '21, as they…
- Draw down their excess saving and benefit from strong labor markets and increasing wages

Source: JPM

Underpinnings of DM Outlook: Record Profit Margins /Delicate Balancing Act





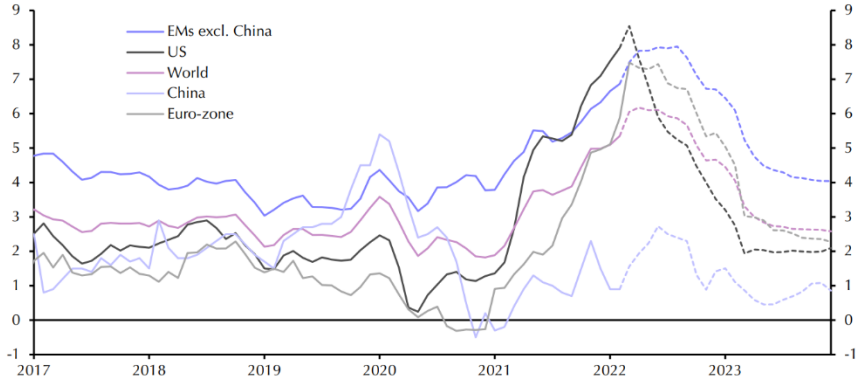
Source: MSCI, JPM

- Post–pandemic productivity surge and more recently increasing pricing power underpin record profit margins and…
- Strong industrial production, capex and employment growth

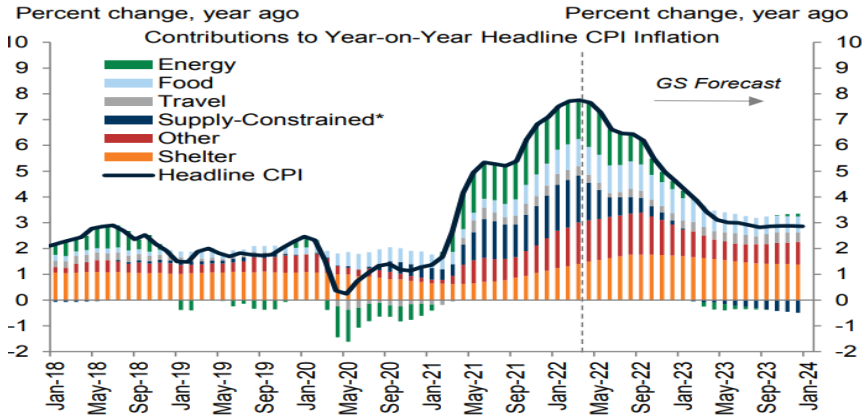
- Baseline outlook assumes DM wages rise at ~ 4% pace next year which is consistent with 2.5% inflation rate, assuming productivity growth remains at ~1.5%
- "2.5% inflation needed to hit sweet spot: high enough to prevent margin slide, low enough to contain central bank tightening" (JPM economists)

Global Inflation Expected to Peak This Year But Remain Elevated

Global Headline Inflation (%)



Drivers of US Headline Inflation



* New and used cars, car parts, and household furnishings and operations.

- Recent surge in CPI inflation largely global phenomenon (ex. China)
- Due initially to rising energy and food prices [1] and pandemic-related distortions
- Invasion of Ukraine added renewed pressures on commodity prices[2]

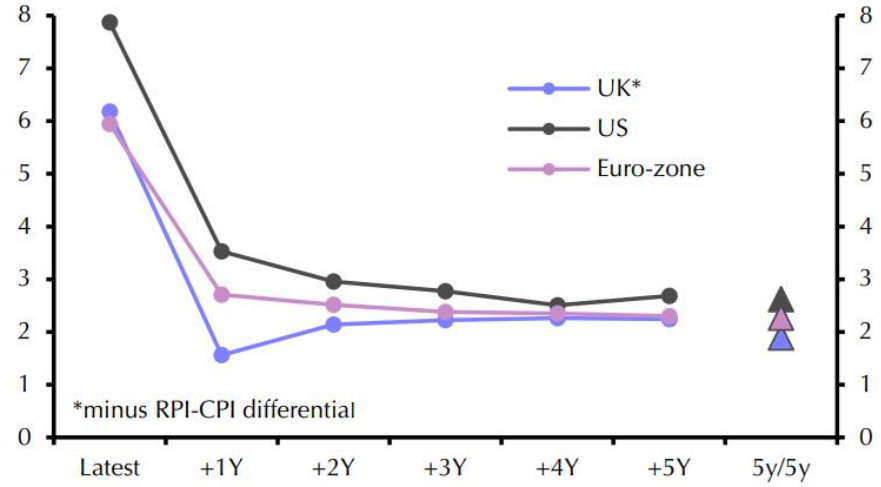
- Expected moderation in US and DM inflation in latter half of ‘22 and ‘23 due to base effects[3] and unwinding of reopening distortions
- Continuing pressures on service prices, particularly rental equivalents, to keep inflation above pre-pandemic trend

Source: Refinitiv, CE, BLS, GS

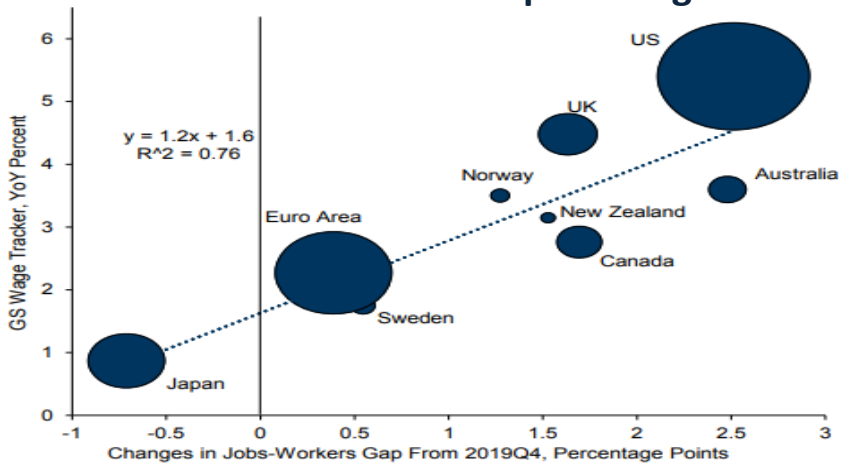
1. Rising energy prices accounted for roughly half of DM inflation rise in ‘21
2. War in Ukraine expected to add 1%-pt. to global headline inflation this year (CE estimate)
3. Even if energy prices remain at current highs, energy’s contribution to DM inflation will drop 2%-pts. in ‘23

Inflations Expectations & Wage-Price Spiral: Key Identifiable Risks for Central Bankers

Investors' Expected Path of Inflation (%)



G10 Jobs-Workers Gap vs. Wages



- Even though near-term inflation expectations have increased…
- Longer-run expectations as implied by zero- coupon inflation swaps remain anchored
- Marked contrast with some 40-years ago when "Bond Vigilantes" pushed 10-year Treasury yield to 15.8%

- Tight labor markets, however, currently putting upward pressure on wages
- GS jobs-workers gap model[1] points to strong year-over-year wage growth: 5.25% for US, 5.5% for UK, and 2.5% for Euro area.

Source: Haver Analytics, GS

1. Jobs-workers gap-- total number of jobs (i.e., employment plus job openings) minus number of workers in labor force

Central Bankers' Framework for Soft Landing

- Major DM Central Banks are expected to raise their policy rates to prevent wage-price spiral from taking hold

Policy Rate			
	Q1 '22	Q4 '22	Q4 '23
US	0.38	2.38	3.13
Euro Area	- 0.50	0.00	0.75
UK	0.75	1.75	2.00

Inflation Rate[1]		
Q1 '22	Q4 '22	Q4 '23
5.3	4.2	2.5
2.7	2.5	1.8
5.1	4.4	2.3

GDP	GDP	
Q1 '22	Q4 '22	Q4 '23
5.7	3.1	2.0
5.3	2.5	2.2
7.4	3.9	1.2

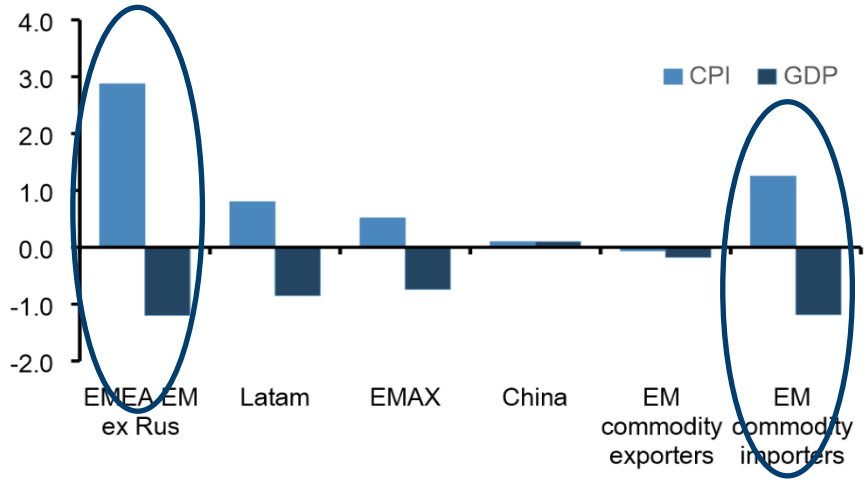
- Two key points re forecasts:
  - As discussed in recent SECOR papers[2], neutral policy rates have declined significantly over past 40-years; now increases of only ~100 - 200 bps. required to raise policy rates to near or slightly above normal
  - Baseline GDP forecast calls for growth rates to moderate but not contract in '22 and '23

1. The GS forecasts are close to the consensus — e.g., consensus GDP forecasts for '22/'23 — US: 3.2%/ 2.1%, Euro area: 2.8%/2.4%, UK: 3.8%/1.6%.
2. "Stagflation: Four-Decades Ago Versus Today: Similarities & Differences (April '22), "Revisiting Neutral Real Rate Assumption" (May 2019).

Emerging Market Economies: Growth Revised Down / Inflation Up

Major EM Groupings

%-pt. change vs. mid-February Forecasts



Source: JPM, CPI excludes Turkey

- Since invasion of Ukraine 2022 inflation and growth outlooks have been revised significantly for…
- EM Europe ex Russia: inflation +3%-pt. and growth -1%-pt. for and for EM commodity importers: inflation +3%-pt. and growth — 1%-pt.

Selected EM GDP Forecasts (%)			
	2021	**2022**	**2023**
China	8.1	4.2	5.0
India	8.7	8.0	6.5
Russia	4.7	-10.0	0.0
Brazil	4.6	0.8	1.6

1. Principal changes in GDP forecasts for 2022: Russia revised down from 2.5% to – 10% and Brazil revised up from 0.5% to 0.8%

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China's Risks: Manager Survey

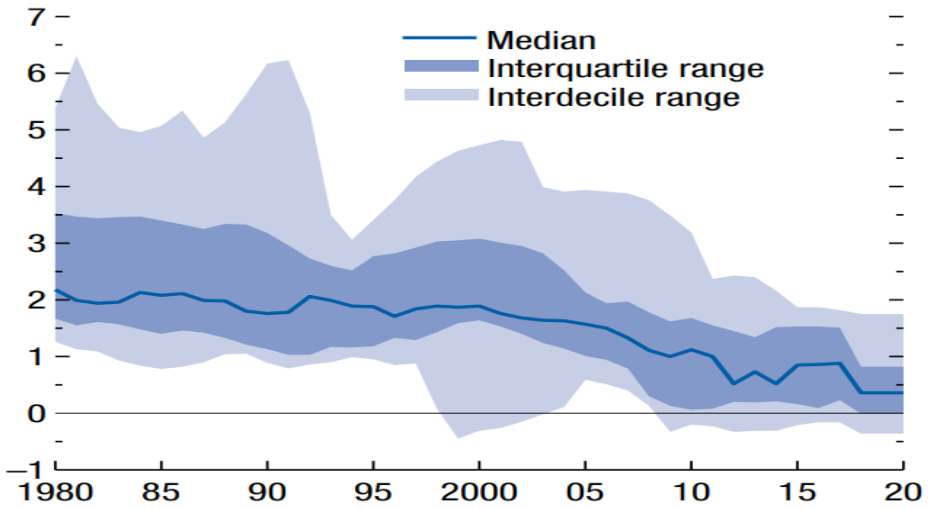
I. Risks Related to Real Estate Sector: Serious Growth Headwind for China's Economy
   - Property sector significant constraint on growth but not likely to trigger broader recession
     - Stop-gap fixes appear to be working, although offshore bond-investors may face steep losses
   - "China has a growth problem" / overinvesting in fixed assets gross misallocation of capital
   - Our conversation with other market participants note the upcoming re-election of Xi Jinping bears watching
     - Reluctance to invest in China's real estate
     - Less bearish if post-election cabinet were more market-friendly

II. Current Shutdowns / China Zero-Covid Tolerance Policy / Fixable Problems
   - Current shutdowns short-term speed bump that will be addressed
   - Increased vaccinations, introduction of mRNA vaccines, new drugs, and modifications in zero-tolerance policy

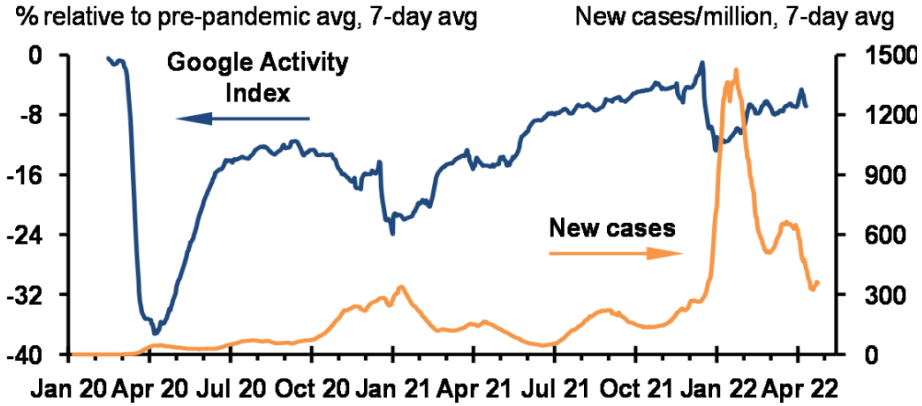
III. China's Regulatory Reset / Eventual Implications Difficult to Assess at This Juncture
   - Markets may have overreacted / Regulatory easing evident in areas where impact on GDP is potentially significant

Two Important Assumptions: Low Neutral Rate & Contained Virus

Estimated Neutral Rate (%)[1]



Global Mobility & New Covid Cases



Source: IMF, Google, OWID, JPM

- Neutral policy rate (r^*) has declined and become more homogenous across major DMs over past 40 years…
- Decline largely attributed to demographics productivity, and saving behavior

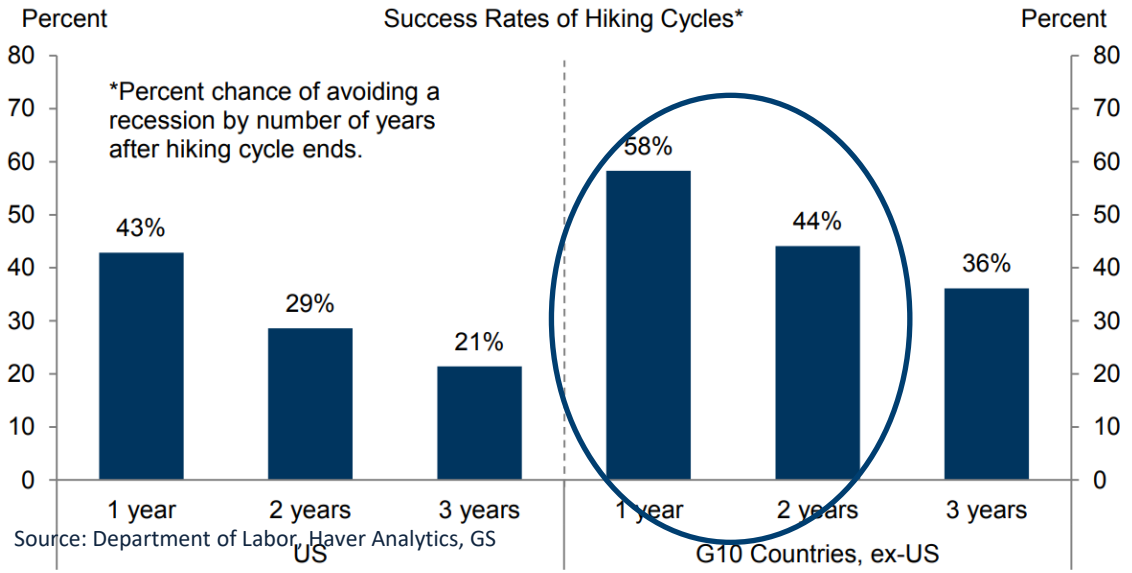
- New COVID cases down considerably from recent peak
- Expect most economies (ex. China) to "live with virus" and mitigate health risk by vaccinations, increased immunity, and widespread use of oral antiviral — e.g., Pfizer's Paxloid

1. Neutral rate is the theoretical rate that keeps an economy stable. IMF estimates include 15 major DMs

Recession Risk: Principal Conclusions

- Risks have increased since the invasion of Ukraine
- Exposure to rising commodity prices and recent geopolitical events not uniform across countries and regions
- Euro area more vulnerable than the US and most other major DMs[1]
- Achieving soft landing possible but far from assured / G10 history puts…
  - Odds of avoiding recession after rate hiking cycle ends at 58% after 1-year and 44% after 2 years
  - Odds lower for US and range of outcomes widens when other factors considered

Soft Landing US & G10 Countries[2]



Source: Department of Labor, Haver Analytics, GS

1. Capital economist notes: Europe due to its lower- trend growth ~1% vs. ~2% for US and being larger importer of commodities makes Europe more vulnerable to a recession than the US in the current environment
2. Only 4 US recessions since '82 and 12 for since '45. Using G-10 data and defining recessions as year-on-year negative per capita growth provide more robust data set for GS analysis.

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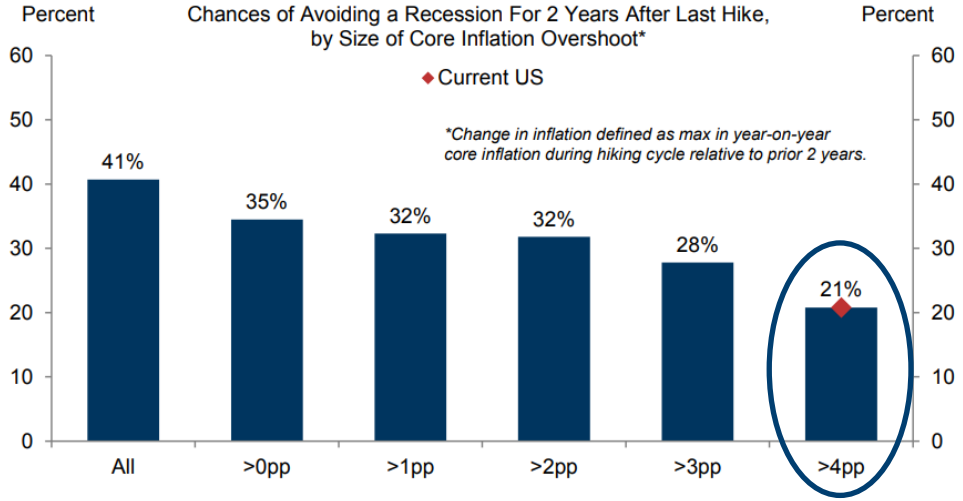
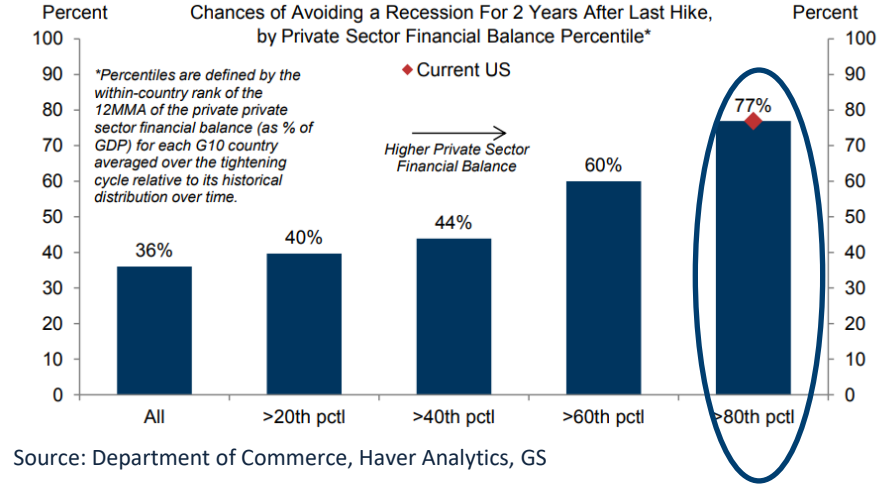
Recession Risks: Current Anomalies Allow for Pessimism & Optimism

Soft Landing Odds Fall When Inflation High



- Soft landings hard to achieve once an economy is overheating and inflation is far above target
- Based on the historical G10 record, only a 21% chance of the US -- with inflation >4pp above target -- avoiding a recession over the next 2+ years

Soft Landing Odds Rise When Financial Balances Strong



Source: Department of Commerce, Haver Analytics, GS

- In contrast, the G10 data indicate that the odds of avoiding a recession are very high when financial balances are strong
- With US financial balances > 80th percental currently, G10 data imply 77% chance of avoiding a recession over the next 2+ years

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Pulling It All Together

- **Invasion of Ukraine Additional Hit to Commodity Prices and Inflation**
  - Spark requiring revisiting January's macro forecasts
- **Changes in Baseline Macro Outlooks Relate Largely to Degree, Not Transformative**
  - Global growth forecast trimmed from above to about in line with potential
    - Consumers and businesses still in strong financial positions
    - Commodity importers hit harder than exporters
  - Inflation still expected to peak this year but…
    - At higher levels and perhaps quarter or so later than expected previously
  - Central banks still expected to normalize rates but
    - Increasingly apparent that they need to move at faster pace
- **Identifiable Macro Risk Still Manageable But Higher Than In January**
  - Soft landing remains as most likely scenario, although…
    - Central bankers confronted with delicate balancing act
  - Virus (ex China) and other identifiable risks largely contained
  - Geopolitical risks "wild card"

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