



Attention shifting from inflation to the growth outlook

We continue to expect inflation to return to around 2% and the key investor debate to shift back to the growth outlook. Our expectation remains a soft landing, but we outline the main risks investors should watch.

Over the past few years, the inflation outlook has been the key investor debate. Will it slow? If so, will it reach central banks' target rates of around 2%? And if not, how much interest rate pain must households, businesses and governments swallow?

Our inflation view has not changed in the past couple of years. We still see inflation slowing, with the initial deceleration of annual inflation in the G20 countries from 11% in late 2022 to 6% a year later the easy part. While the subsequent slowdown to around 2% will be the more difficult part, we remain confident that inflation will eventually slow to the central banks' targets – primarily because they have the capability and intent to achieve this outcome. As this unfolds, we see a soft landing, with growth remaining below trend until spare capacity rises to more normal levels. In this scenario, equity markets should grind higher.

However, there are four broad ways our base case may not play out, which we list from most to least likely.

- **A negative demand shock would reduce inflationary pressures.** This would be positive for markets if it were minor as interest rates would decline, but a recession would be avoided. A minor shock could be driven by a larger-than-expected impact on household, business and government finances from the interest rate hikes over the past two years. A major shock would be negative for markets, with potential triggers being a collapse in commercial property prices, a high-profile business model failure or the inevitable repeat of the 2009/10 European sovereign debt crisis.
- **A negative supply shock would push up inflation,** and this would be negative for markets as interest rates would rise, crimping growth. International confrontation remains the most likely trigger, either via preparations (such as faster decoupling, onshoring or friendshoring) or confrontational acts (such as war). When analysing these risks our guiding principle is that very few countries want a war, but all want to be prepared for it. Accordingly, we expect the decoupling trend to strengthen further, underpinning inflation as production moves from low-cost countries to more reliable, but costlier, countries. The hit to markets would be more severe if decoupling happened quickly, as supply shortages would spike inflation and force countries to retaliate, further accelerating decoupling.
- **A positive demand shock would also boost inflationary pressures.** We believe this would be bad for markets as the prospect of higher interest rates would hurt the growth outlook. By our reckoning, the most likely sources are a premature easing of monetary policy by central banks or another bout of government spending. Too-early interest rate cuts seem unlikely given central bankers' statements to date on the dangers posed by inflation, but these attitudes may change and must be monitored. Additional fiscal stimulus of the scale seen during covid seems unlikely; however, the slew of elections in 2024 provides the opportunity for fiscal largesse from a newly elected leader who wants to solidify their popularity or who has strong economic and industry ideologies – especially if they believe that the central banks can foot the bill by printing money. After all, the central banks financed a large part of government spending during covid and, putting aside the spike in inflation, it could be argued this financing process didn't fail.
- **A positive supply shock would push down inflation,** with this scenario boosting markets as the growth outlook would improve without upward pressure on interest rates. We

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think this is the least likely scenario because the trend towards decoupling is structural and strong, reflecting the increasingly rivalrous relationship between China and the US. Moreover, productivity enhancements, like those many predict to be unlocked by recent rapid advances in artificial intelligence and computing power, typically take many years to affect the broader economy even though they can have large impacts on particular industries and companies in the shorter term.

Looking ahead, we see inflation and interest rates ebbing as the main focus for investors. In their place, the growth outlook will move to the top of investors' minds, which is the usual state of affairs. In this environment, we are watching other risks closely.

While the geopolitical landscape is increasingly fraught, few countries want confrontation. This reduces the likelihood of the worst-case scenarios. For instance, we continue to expect that China will not make a move on Taiwan, unless the US exchanges support for Taiwan for Chinese economic and military guarantees. We also view a regional Middle Eastern conflict as unlikely given well-communicated redlines and international pressure for stable energy prices, while Russia's invasion of Ukraine seems to be in a broad stalemate, with the upcoming US election potentially facilitating a ceasefire.

Domestic political risk is heightened given the large number of elections. On average, government shifts to the left of the political spectrum are negative for equity returns, while shifts to the right are positive for returns. However, increasing partisanship and decoupling are driving changes in economic and industrial policies that alter not only the size of the economic pie but also how it is sliced up. For instance, we believe a second Trump administration would be, on balance, more pro-growth and positive for equity returns than a Democrat President, but there would be winners such as the energy industry that will benefit from deregulation and losers such as companies perceived as "woke."

Will China stimulate its economy? In our view, recent policy actions from the government have been aimed at reducing downside economic risk rather than creating upside. We remain cautious towards the Chinese economy and corporate governance but recognise that the likelihood of larger-than-expected stimulus is not zero.

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