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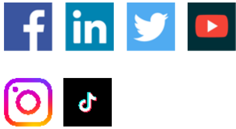
Date: September 7, 2022
Topic: Macroeconomic



Global X House Views - September

Elevated inflation, slowing global economic growth expectations, and reduced central bank liquidity remain the key economic considerations. Together, they create a typical late cycle environment, but with a few extra complications from the war in Ukraine.

Europe's growing energy crisis has implications for inflation and economic growth, while also presenting investment opportunities.

Global Macro

The Federal Reserve (Fed) heightened the focus on inflation and interest rates at their economic policy symposium at Jackson Hole. The Fed's commitment to bring inflation under control has global economic implications as central banks may need to keep pace with the Fed despite economic weakness.

While it remains a balancing act between interest rate sensitivity and economic growth sensitivity, Jackson Hole reset expectations to focus more on inflation.

Regional Macro

U.S. Equities	Over
International Developed Market Equities	Under
Emerging Market Equities	Neutral

United States

The Fed faces a challenging balancing act between elevated inflation and slowing economic growth. However, they're raising interest rates while the U.S. economy remains in a strong position relative to most economies globally. Unemployment remains low and pandemic savings provide a buffer for consumption. However, we remain concerned that consumption growth cannot exceed income growth for too long. The potential negative feedback loop between consumption and employment remains a focus area.

Spending and income are two sides of the same coin. While gross domestic product (GDP) points to a declining U.S. economy, gross domestic income (GDI) continues to reflect growth. Taking the average of these metrics reflects a stagnant U.S. economy in the first half of 2022.[1] We believe Q3 is likely to include elevated spending from the summer of excess. This is likely to be followed by spending curtailment into fall and winter.

U.S. inflation may have peaked, but at high levels thus forcing the Fed to remain restrictive. Strong dollar, high mortgage rates, lower commodity prices, lower demand, and reduced supply chain pressures are likely to help reduce inflation over the next year.

The Fed will accelerate their balance sheet reduction in September to $95bn per month and we expect a 75 basis point (bps) increase at their September FOMC meeting.[2] We expect this faster pace of quantitative tightening (QT) to be a continued source of volatility.

The U.S. dollar should stabilize over the medium-term amid hawkishness from other central banks and slowing economic data. Internationally exposed companies, like tech companies, should benefit from dollar stabilization.

International Developed Markets

European economic growth and inflation trends are a key concern. Energy supply remains uncertain and climate change has dampened supply provided from hydro and nuclear power. Following 10 days of maintenance in July, unscheduled maintenance of Nord Stream 1 stopped natural gas supplies to Europe for three days from August 31 to September 2nd.[3] Gas supplies remained suspended, without a timeframe for resuming operations.[4] At stake is Europe's ability to refill their storage tanks ahead of winter. In Germany, where the situation is the most uncertain, the debate over prolonging operation of the nuclear power plants could give a fresh tailwind to commodities like uranium.

The euro has reached parity with the dollar, with the European Central Bank (ECB) being forced to confront higher prices despite economic weakness. At their last meeting, the ECB increased interest rates 50 basis points (bps) to 0%, and a move of a similar magnitude is expected in September.[5]

The Bank of Japan has not yet started raising interest rates.

Emerging Market Equity

Delisting risk for U.S.-listed Chinese companies has decreased substantially with the recent audit agreement. However, the deteriorating economic data coming from China and the current zero covid policy leaves the region with some risks. Risk takers may see buying opportunities amid cheap valuations as we expect more upside than downside in the medium term.

Asset Class Views

Current conditions are typical of a late cycle environment.

We expect market volatility to remain elevated through the interest rate hiking cycle, although aggressive tightening by the Fed and the ECB seems mostly priced into the market. At this stage, we prefer equities over fixed income because real yields are still in negative territory. In fixed income, we prefer lower duration assets due to the rising rate environment. However, long duration Treasuries can provide some protection as recession risk rises.

The inflationary environment creates a favorable backdrop for commodities. However, a strong dollar and tightening financing conditions could make commodities slightly less attractive at this stage. We prefer commodities over other assets, but with a somewhat more muted outlook. Chinese uncertainty also clouds the outlook for economic growth focused commodities.

Sub Asset Class & Industry Views

Increased focus on defensive segments with strong cash flows. Preferred sectors include Health Care, Consumer Staples, and Utilities while discretionary consumption remains an area of concern. For more detail, please refer to our sector views blog post.

Inflation protection should be balanced with quality, defensive equity positions. We also view assets tied to derivatives like covered call strategies and those targeting rising interest rates as potentially attractive with volatility remaining elevated.

Product Opportunities

In light of the focus on energy security, the Inflation Reduction Act (IRA), and recent Fed commentary, we view a few key areas of the market favorably in this environment:

- Climate change themes poised to benefit from the IRA and the increasing need for alternative energy solutions. We like renewable energy producers and cleantech companies in particular.
- Uranium is a specific segment of the energy market with attractive supply & demand fundamentals, and a changing narrative around nuclear energy. Many countries have either been integrating nuclear power into their energy agendas or have been delaying planned phase outs, bringing additional demand for uranium to the surface.
- Covered call strategies that sell options premiums on some of the major US indexes like the Nasdaq 100 or S&P 500. Markets sold off in August, continuing the push and pull nature of the equity markets recently. Selling options premiums to monetize volatility and stay invested could be appealing to investors.

Commodities continue to be a bright spot in the market, as the threat of rate hikes and sticky inflationary pressures persist in the global economy. We view areas like lithium and uranium as particularly attractive given their long-term nature and strong fundamentals right now. These commodities are less sensitive to short term pressures around China for example, which has led to outperformance this year.

The IRA bill was a boon for renewable energy companies. The nearly $370 billion bill is largely targeted towards addressing climate change. Renewable energy and cleantech companies saw a short-term boost in performance as a result, but we believe this will help spur investor interest towards solar and wind companies, as well as renewable and cleantech companies. The economics of renewable companies are also improving and the long-term shift to integrate these solutions to address climate change serves as an attractive value proposition.

Equity markets have been trending sideways for most of Q2 and Q3. For investors, one way to tackle this is by taking a more nuanced approach towards equities. One solution we like right now are covered call strategies, which have benefited when market volatility has risen given that call writing premiums are positively correlated to volatility. Covered call strategies also allow investors to stay in the market but in a somewhat more defensive manner. Given that the Fed has signaled a hawkish trajectory, the potential income collected from covered call writing can be particularly attractive too. Another solution is for investors to make their equity exposure more domestically oriented towards the US, as the strong dollar affects global markets, and the more positive outlook of the US economy relative to the rest of the world.

Footnotes

1. Hilsenrath, J. (2022, August 29). A different take on the U.S. economy: Maybe it isn't really shrinking. *The Wall Street Journal.* https://www.wsj.com/articles/a-different-take-on-the-u-s-economy-maybe-it-isnt-really-shrinking-11661696041

2. Torres, C., & Matthews, S. (2022, April 6). Fed officials weigh pruning balance sheet by $95 billion a month. *Bloomberg*. https://www.bloomberg.com/news/articles/2022-04-06/fed-officials-weigh-shrinking-balance-sheet-by-95-billion-month
3. Steitz, C., & Escritt, T. (2022, August 19). Nord Stream 1 pipeline to shut for three days in latest fuel blow to Europe. *Reuters*. https://www.reuters.com/business/energy/gazprom-says-nord-stream-1-pipeline-shut-three-days-end-aug-2022-08-19/
4. Pavlova, U., & Cooban, A. (2022, September 5). Russia cuts off gas exports to Europe via Nord Stream indefinitely. *CNN*. https://www.cnn.com/2022/09/02/energy/nord-stream-1-pipeline-turned-off/index.html
5. Reuters. (2022, August 28). ECB policymakers make the case for a big rate hike. *CNBC*. https://www.cnbc.com/2022/08/28/ecb-policymakers-make-the-case-for-a-big-rate-hike-.html

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