Q3 2022 OUTLOOK SUMMARY

# RATES, RECESSION & RISK-OFF?

**Over the past year, the investment backdrop has transformed from one of stimulus and spending to one of inflation and tightening financial conditions, with the battle to control inflation now the overriding concern for investors. An intensifying slowdown in activity around the globe and rising concerns over recession in many economies will confront investors and policymakers as the second half of this year unfolds. While it's a difficult environment to traverse, we offer the following views from across PGIM affiliates to help investors navigate the uncertain outlook:**

- Rising recession fears gripped global markets this quarter as an unpleasant combination of macro events led stocks into bear market territory and investors assumed a "risk off" stance across most asset segments. Declines in bonds were also substantial with the bond bear market growling even louder. The decline in stocks was driven primarily by the significant compression in earnings multiples. All major equity regions are now trading at a discount to their 10-year averages; however, multiples could see more downward pressure in the near term as inflation runs hot and central banks stay vigilant. Corporate earnings have been a key pillar of support for stocks during the recovery from the pandemic and analyst forecasts for 2022 are still upbeat. However, we see significant scope for earnings disappointments in the second half given tighter financial conditions and macro headwinds. Despite equity market declines and improved valuations, we remain cautious on stocks due to the combination of heightened recession risk, hawkish central banks, and significant risk of corporate earnings downgrades.

- After the markets' thorough drubbing in the first half, fixed income's next episode starts with a more balanced picture of elevated interest rates, wider credit spreads, and shorter durations. It's too soon to sound the all-clear on periods of jarring volatility, but from a long-term perspective, exposure to developed-market duration is becoming more compelling after the broad repricing and with the looming moderation in global growth. The new, fraught reality for global corporations is a function of a highly compressed credit cycle. For many, bloated inventories, persistent supply chain disruptions, and squeezed margins point to a period of downward revisions in corporate earnings estimates.

- The uncomfortable reality for policymakers is that the primary sources of elevated headline inflation this year are supply driven — tied directly to the war in Ukraine and related Russia sanctions — which challenges the effectiveness of monetary policy as a tool for addressing the problem. In our view, we are not yet at the point where a US recession is an inevitable outcome, but the prospects for one continue to build in Europe. Adjustments in hiring plans and greater impact from foreign currency translation on reported profits are among the shifts that are impacting full-year financial outlooks at this stage. The advantages and attributes of high-quality growth companies tend to attract greater attention from investors during slowing periods, given their relative resiliency to economic headwinds.

- The outlook for global real estate markets is clouded by elevated uncertainty, with higher inflation, geopolitical conflict, supply disruptions and rising interest rates contributing to a volatile backdrop. Real estate has been resilient to shock in recent years, but downside risks have risen, limiting tactical investment opportunities. Increasingly, the focus for investors is on assets in sectors and markets that deliver dependable cash flows and in which demand is structurally supported by favorable underlying trends.

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