INVESTMENT STRATEGY INSIGHTS

Global Inflation Bites

September 12th, 2022

Europe's Perfect Storm

- Deteriorating economic health driven by an unfolding energy crisis warrants caution in European equities

Monetary Tightening Goes Global

- An aggressive global tightening cycle increases the odds of a global recession, justifying an underweight risk posture

Awaiting August CPI

- While August may see some inflation relief, the Fed is likely to maintain its rate hike path to pressure inflation further

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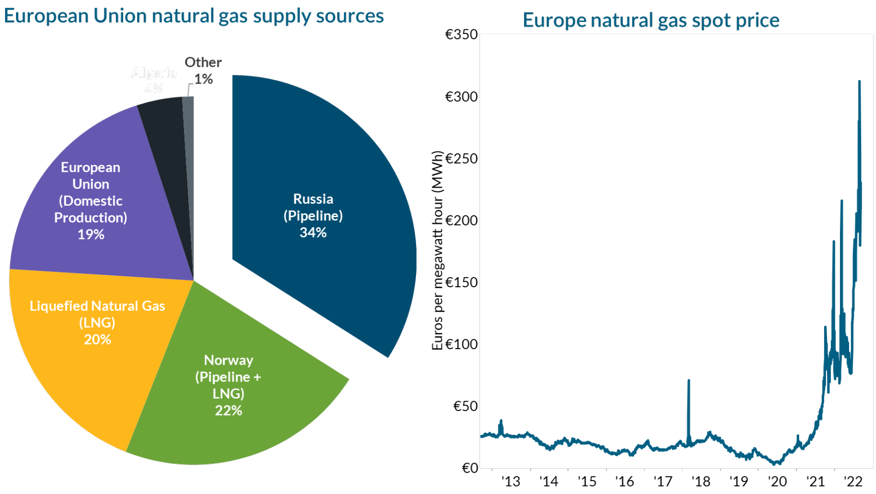
Europe's Perfect Storm

- **ECB Takes Action.** It appears that the monetary cycle is now increasingly synchronized across the world as the pace of tightening continues to accelerate in several countries. Notably, the European Central Bank (ECB) raised interest rates by an unprecedented 75-basis points last Thursday, following up on a July rate hike while signaling a path for future increases. Raising rates at such a pace comes against a backdrop of surging inflation, largely driven by Russia's invasion of Ukraine and the region's escalating energy crisis.
- **Europe's Energy Crisis.** The European economy faces a tough road ahead, particularly as its unfolding energy crisis threatens to snowball into shortages come winter. For example, European natural gas prices have surged a little under 4x at their year-to-date peak. This has had a mix of direct and indirect effects on the broad economy, as evidenced by the -3.5% reading in Glenmede's Eurozone Leading Economic Indicator, which seeks to provide estimates of expected GDP growth over a 6-12 month window.
- **Reducing European Risk.** Despite the pronounced economic uncertainty on the continent, European stocks do not appear to offer differentiated valuations relative to other foreign equity markets. Glenmede's Global Expected Returns Model estimates European equities currently sit at the 46th percentile of fair valuations. In comparison, Japanese and emerging market equities are at the 22nd and 45th percentiles, respectively, suggesting that market valuations may not be properly reflecting the macroeconomic risks in Europe. As such, investors should consider underweighting European equities in their portfolios in anticipation of a re-rating of risks.

Deteriorating economic health driven by an unfolding energy crisis warrants caution in European equities

Chart of the Week:

Europe faces a tough road ahead as its energy crisis continues to unfold



Source: Glenmede, Evercore ISI, FactSet

Data through 9/9/2022

Shown in the left panel are the sources of natural gas supply for the European Union as of the full year 2020. Shown in the right panel is the spot price for natural gas via the Title Transfer Facility in the Netherlands, measured in euros per megawatt hours (MWh).

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Monetary Tightening Goes Global

- **World-Wide Rate Hikes.** With inflation at multi-decade highs in many countries, central banks around the world have pivoted toward tighter monetary policy. So far in 2022, nearly four dozen countries have raised their policy rates, joining the Fed in quickly pushing rates higher. This, in turn, also ramps up the risk that some nations could fall into a recession as consumers and companies pull back on their spending.
- **Global Economic Weakness.** The Global Manufacturing Purchasing Managers' Index, a survey of businesses regarding the current environment, fell from 50.8 in July to 49.3 in August, its lowest since June 2020. The survey showed that output only rose in ten of the 30 economies for which data are available, and in five of those, the gains were only marginal. Meanwhile, production losses were recorded in the U.S., Eurozone, U.K. and Japan, as new orders continued to fall at an increased rate in August and inventory levels rose amid weaker than anticipated sales.
- **Valuations Remain Stubbornly High.** After rebounding from the June lows, markets have returned to levels at which they command significant premiums to fair value. However, with the recent decline, large cap stocks still do not appear to reflect the growing difficulty of the economic environment. According to Glenmede's Global Expected Returns model, large cap stocks experienced a considerable decline within recent weeks, though remain near their 75th percentile. All else equal, expectations of persistent tightening from central banks and the associated economic fallout should weigh on those premium valuations, suggesting the ongoing bear market may have further room to fall.

An aggressive global tightening cycle increases the odds of a global recession, justifying an underweight risk posture

Awaiting August CPI

- **August CPI Preview.** The August print of the U.S. Consumer Price Index (CPI) will be released this Tuesday, with consensus expectations calling for an 8% annual pace of inflation. The Cleveland Fed's Inflation Nowcast shows August's month-over-month Core CPI reading, which excludes the typically more volatile food and energy components, is tracking nearly 0.5% month-over-month, a level that is still well above the Fed's preferred target range of 0.0-0.3%.
- **Peak Inflation?** With consumer prices growing at a slower pace in July, there are some encouraging signs that some relief may be in the pipeline. For example, annual changes in CPI are highly correlated with commodity prices, which have recently turned lower via the Bloomberg Commodity Index. Meanwhile, the sustained decline in gas prices has helped offset some cost pressures and is likely to reflect in headline consumer price inflation for August as well. However, there remains much uncertainty over the inflation outlook due to Russia's war in Ukraine and the associated risk with energy supplies.
- **Fed Reaction Function.** While there may be signs that the economy has slowed, it appears that the recent run of weaker economic data is not yet likely to prompt a pivot from the Fed. Fed Chair Powell reaffirmed his commitment to a hawkish policy stance in a speech last Thursday, noting that the Fed is now focused on acting "forthrightly" against inflation to ensure that consumers do not come to view rising prices as the norm. Such statements appear to have solidified expectations for a third straight 0.75% rate hike later this month, with fed funds futures now pointing to a roughly 90% chance of such an increase.

While August may see some inflation relief, the Fed is likely to maintain its rate hike path to pressure inflation further

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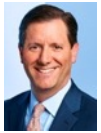

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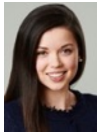

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GLENMEDE CORPORATE FACTS

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