



# The Storm in Financial Markets Is Not Over Yet

Inflationary pressures may be receding, however.

October 2022

Things are not getting easier. The trends that made the first half of the year so difficult to navigate continued in the third quarter. The data suggest that the outlook for growth has deteriorated further and that we are now at the precipice of a global recession. Meanwhile, most central bankers have decided that they are at an existential moment: Inflation must be curtailed now.

The monetary policy dial has therefore been set to “maximum hawkishness.” This combination of hawkish central bank policy and a bleak outlook for growth has unleashed a storm in financial markets, and there has been nowhere to hide: Every major asset class has produced substantial negative returns for the year. What’s in store for Q4? Although some contours are changing, we’re probably in for more of the same.

## Growth Challenges Are Long Term in Nature

The global economy has been hit by several shocks, which are likely to weigh on growth for some time to come—and in some cases, maybe years. The biggest of these is the monetary shock induced as central banks have stepped up their fight against inflation. It’s well known that monetary policy works with long and variable lags, and I believe we are still a



**Nikolaj Schmidt**  
Chief International Economist

couple of quarters from feeling the full economic impact of monetary tightening.

At the same time, commodity prices have surged since Russia’s invasion of Ukraine, which has eroded households’ and businesses’ purchasing power and put central banks under pressure to tighten monetary policy. More importantly, Russia’s decision to curb the export of gas to Europe will force Europe to ration energy consumption. The impact of energy rationing will be most acutely felt in the coming year, but we likely face a few years of reduced energy availability.

No energy means no growth. I expect Europe to go through a full-blown recession, and as the European Union accounts for roughly 17% of global gross domestic product (GDP), this will have worldwide ramifications. Furthermore, energy rationing represents a very complex shock: As production is curtailed, we might find ourselves with renewed supply chain problems, which in turn could lead to adverse inflation outcomes.

“...we are still a couple of quarters from feeling the full economic impact of monetary tightening.”

“...the combination of slower growth and lower inflation should provide central banks with some breathing space.”

In China, growth continues to be hampered both by the authorities' dynamic “zero-COVID” policy and by their decision to finally tackle the property sector. Including auxiliary industries, the property sector accounts for 25% to 30% of China's GDP—shrinking and regulating will be a multiyear process, and I believe that strong growth outcomes are unlikely until this process is much further down the line. Slowing Chinese growth will be felt across the globe, particularly in commodity-producing economies.

Finally, in the U.S., Federal Open Market Committee Chair Jerome Powell has made no secret that he will deliver price stability even if this comes at the cost of an economic recession. In my view, the extent of monetary tightening administered by the Fed is such that America is about to enter a central bank-induced recession.

#### **The Inflation Picture May Be Changing**

On the inflation front, I hold some hope that the contours are starting to change. A recession is highly likely and commodity prices are falling. At the same time, high-frequency data point to a healing of global supply chains. With more time, we should see the full impact of improved supply chains on both goods availability and prices. Central banks—in particular, the Fed—will not rush to respond to minor improvements in the inflation outcomes, but over time, the combination of slower growth and lower inflation should provide central banks with some breathing space. Unfortunately, we are not quite at that point yet.

On the monetary policy front, global central bankers emerged from the annual Jackson Hole conference with a very strong consensus: Act now to avoid high inflation expectations becoming entrenched. This has led

to an aggressive front-loading of the policy tightening. In my view, this is being taken too far, and, as I see it, it is almost certain that central bankers will be forced to change their tune as it becomes obvious that they have triggered a global recession. When will this policy pivot occur? Who knows? We just had a hawkish pivot—it's probably best not to hold your breath waiting for the U-turn.

So where does this leave financial markets? At the risk of oversimplifying a very complex backdrop, the price of money (interest rates) is going up at a time when growth is declining. Risk assets tend to like cheap money and high growth, so it's hardly worth saying that the current backdrop is kryptonite for risk assets. Consequently, I expect the U.S. dollar and credit spreads to continue their ascent and equities to continue their descent, albeit less dramatically than at the beginning of the year.

Having said that, too much good news may not be required to spark a rebound in risk assets. More fundamentally, if indeed inflation is about to peak and if growth is slowing to the extent I expect, might we expect more agreeable communication from central banks? Given the Jackson Hole consensus, we are not at this point yet, but we could get there over the next few quarters. It's also worth mentioning that a decline in commodity prices is an integral building block for the recovery process. Lower prices of commodities will, over time, restore household purchasing power and take the pressure off central banks.

So, the storm in financial markets is not over yet. My guess is that we will see another false dawn or two, akin to the summer equity rally, before we see the bottom of the cycle. The bottom may be reached when there is either a decisive turn from the global central banks or a shift in high-frequency growth data.

## INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term. To learn more, please visit [troweprice.com](https://troweprice.com).

# T.RowePrice®

---

### Important Information

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action.

The views contained herein are those of the authors as of October 2022 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation concerning investments, investment strategies, or account types, advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Please consider your own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

**Past performance is not a reliable indicator of future performance.** All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc.

© 2022 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.