

THE GREAT MODERATION

2022 Global Market Outlook





The great moderation

Global economic growth will be slower but still above trend in 2022. This forecast should allow equities to outperform bonds. Inflation has yet to peak, but it will likely decline over the year and as a result any central bank tightening will be modest.



The global economy is poised for a second year of above-trend growth, although slower than 2021.

Andrew Pease, Head of Global Investment Strategy



Introduction

2021 was a year of rebound and recovery; 2022 is likely to be a year of moderation for economic growth, inflation and investment returns.

Developed economies have spare capacity, households are sitting on accumulated savings from the pandemic lockdown, and central banks are planning to remove accommodation only gradually. The global economy is poised for a second year of above-trend growth, although slower than 2021. The three main uncertainties for 2022 in our view are:

1. The durability of the spike in inflation.
2. The extent and duration of the property market-driven slowdown in China.
3. Possible further COVID-19 lockdowns as infection rates increase again or new variants emerge.

We expect the [spike in inflation is mostly transitory](#), although it could reach uncomfortably high levels in early 2022 before declining as supply-side issues are resolved. Meanwhile, Chinese authorities are likely to implement stimulus measures to soften the [property slump](#), however the response may be too late and too small to prevent a deeper downturn. Regarding COVID-19 risks, the success of vaccines and approval of pills to treat infections have made investors more relaxed. The [new omicron COVID-19 variant](#), however, demonstrates that these risks can quickly return.

Our cycle, value, and sentiment (CVS) investment decision-making process continues to score global equities as expensive. The U.S. is the most expensive developed equity market globally in late 2021 and the UK offers the best value. The cycle is still supportive for equities, and it's becoming a larger headwind for government bonds. Sentiment for equity markets is mixed with pockets of euphoria, such as single-stock retail investors, offset by caution from surveys of market analysts.

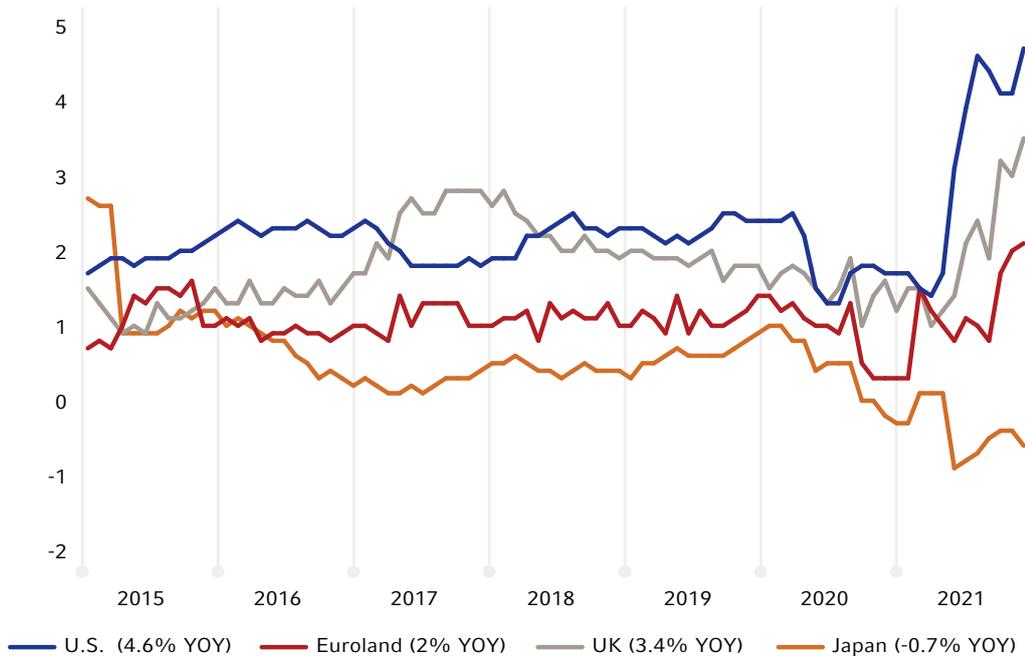
Our asset-class views for 2022:

- Equities should outperform bonds.
- Long-term bond yields should rise modestly. Our target is 2% for the U.S. 10-year Treasury yield by the end of 2022.
- The U.S. dollar will weaken as expectations for 2022 U.S. Federal Reserve (Fed) rate hikes are scaled back.
- Non-U.S. developed market equities could finally outperform U.S. stocks, given their more cyclical nature and relative valuation advantage over U.S. stocks.
- The value equity factor to outperform the growth factor.
- Emerging markets (EM) will remain under pressure from the China slowdown and central bank tightening across other EM economies to contain inflation pressures.

Inflation outlook: Prices to rise, then decline

The main surprise of 2021 has been the [surge in inflation](#) (apart from in Japan) as economies reopened. Some price pressures were to be expected as uneven re-openings from lockdowns disrupted supply chains and as firms hoarded supplies in a move from just-in-time to just-in-case inventory management. The [rise in energy prices](#) and the impact of the [semiconductor-chip shortage](#) on motor vehicle prices has played a significant role in pushing up inflation measures.

Global core inflation rates



Source: Refinitiv®
Datastream® as of
21 October 2021.
YOY = year-over-year.

These issues are only slowly being resolved and inflation may not peak before the end of Q1 2022. Headline inflation could exceed 7% in the United States, but inflationary pressures should subside over the remainder of 2022 as the improving supply side of the global economy catches up with moderating demand. Our modeling suggests core PCE (personal consumption expenditures) inflation in the U.S. could be near the Fed's 2% target by year-end.

The main uncertainty is around [wages and labour supply](#). Workers have been slow to rejoin the labour force due to a combination of generous lockdown payments, inadequate

childcare and school closures that have affected working parents, and early retirement among those over 50. Lower migration has also created labour shortfalls (a particular issue for post-Brexit Britain). We expect most of these workers will eventually return, which would help moderate wage growth. [Labour-market tightness](#), if it persists, could keep upward pressure on wages and inflation and push core inflation closer to 3% than 2% by the end of 2022. This will be one of our key watchpoints for next year.

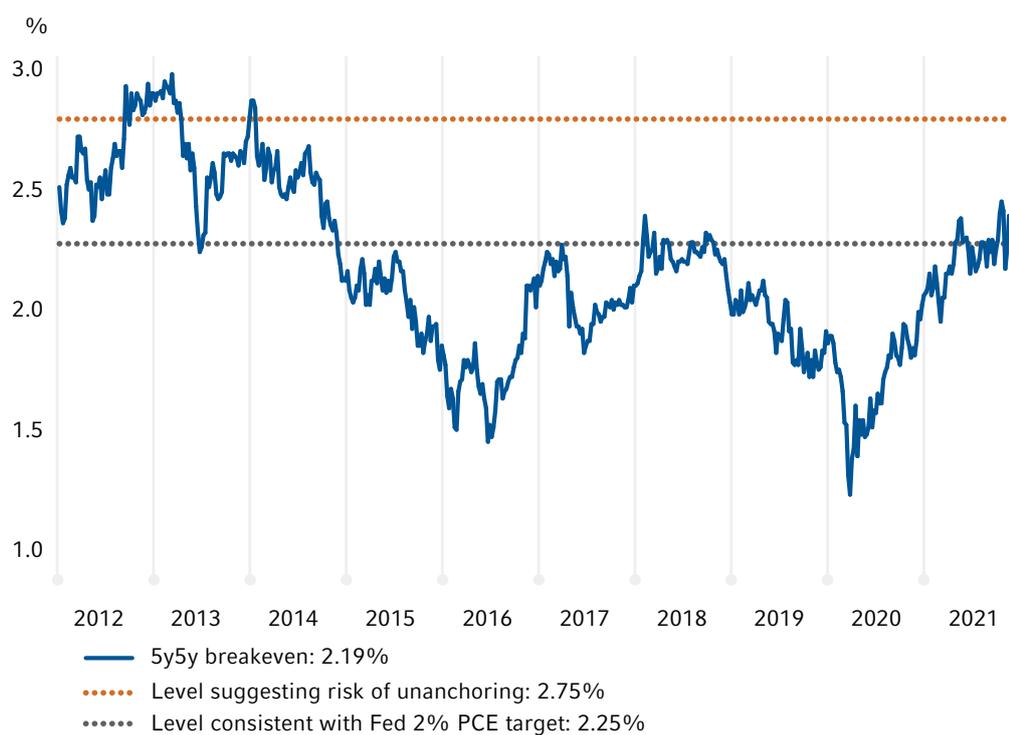
Central banks outlook: Big doves and little hawks

One theme of 2022 is likely to be [central bank divergence](#) between hawks and doves. The major central banks, apart from the Bank of England, are in the dovish camp. The hawks are mostly the smaller central banks. Norway's Norges Bank and the Reserve Bank of New Zealand (RBNZ) have already lifted rates, and the Bank of Canada is expected to tighten early next year. The Bank of England seems determined to lift rates in early 2022. This is despite the UK having lower inflation and a weaker economy than the U.S.

It's unusual to see such a gap between central banks experiencing relatively similar economic conditions. However, the Fed sets the tone for global monetary policy and it seems firmly dovish. The Fed has said it will lift rates only after the U.S. economy has achieved *maximum employment*, which we think is an [unemployment rate of 4%](#). It would take extraordinary growth in jobs to achieve this by mid-2022, which is when the market expects rate lift-off. We think full employment is more likely by the end of 2022. This will give the Fed time to assess inflation risks before embarking on a gradual hiking path in 2023.

One indicator that will give the Fed some comfort is the five-year/five-year breakeven inflation expectation, based on the pricing of Treasury inflation-protected securities (TIPS). This is the market's forecast for average inflation over five years in five years' time. It tells us investors expect inflation will average around 2.25% in the five years from late-2026 to late-2031. The TIPS yields are based on the Consumer Price Index (CPI), while the Fed targets inflation as measured by the PCE deflator. CPI inflation is generally around 0.25% higher than PCE inflation. A breakeven rate of 2.75% would suggest the market sees PCE inflation above 2.5% in five years' time. Market inflation expectations are currently comfortably below the Fed's worry point.

U.S. 5-year/5-year breakeven inflation rate



Source: Refinitiv®
Datastream® as of
24 November, 2021.



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China economic outlook: Growth uncertain

While the developed economies are likely to record above-trend growth in 2022, a question mark is how far China's growth falls below trend. The property market downturn, triggered by the collapse of developers [such as Evergrande](#), is a large drag on economic growth. It's difficult to gauge the exact size of China's residential property sector, but somewhere around 20% of GDP seems in the ballpark according to various estimates. The [knock-on effects to the rest of the economy](#) from wealth effects and local government finances could be significant.

In the past, downside growth risks in China have been quickly countered by monetary and fiscal stimulus. China's leaders, however, are worried about excessive leverage in the property sector and have been concerned that speculation-driven property prices made housing unaffordable for ordinary households. Policy support has so far been modest, with some easing of mortgage-lending rules and allowances for developers to refinance existing debt.

The International Monetary Fund's latest forecasts, published in October, predict China's GDP growth will slow from 8% in 2021 to 5.6% in 2022. These already appear out of date and [sub-5% growth next year seems likely](#). The main unknown is how much economic pain China's leaders are willing to accept to achieve their goal of rebalancing the economy away from an excessive reliance on debt. A reasonable assumption is that there will be some stimulus in the first half of 2022 which should see China's growth trajectory improve toward the end of the year.

The China downturn complicates the investment strategy outlook. On one hand, it will take some steam out of global inflationary pressures, particularly commodity prices. On the other, it adds to the headwinds for emerging markets given China's role as a trade partner. It could also create difficulties for some developed markets. Europe's machinery exports, for example, are exposed to the Chinese construction sector, and this will be a drag on growth and profits for these European companies.



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Stock and bond market outlook: Cycle still favors equities over bonds

The clearest strategy in our view for 2022 is that [equities](#) should generate higher returns than government bonds. Equities should be supported by above-trend economic growth, solid growth in profit and central banks that are only slowly removing accommodation. These same factors will put [upward pressure on government bond yields](#), but this should be modest.

The outlook for other asset classes is more nuanced. Above-trend growth and higher long-term interest rates favour cyclical and value stocks over technology and growth stocks. The rest of the world is overweight cyclical value stocks relative to the U.S., which has a higher weight to technology stocks. This suggests U.S. stocks should underperform the rest of the world. This theme didn't pay off in 2021, and the U.S. was the best-performing market. However, it could succeed in 2022 as COVID-19 fears recede and a more normal cyclical recovery takes hold.

Emerging markets (EM) face challenges from the slowdown in China and inflation pressures that have seen a range of EM central banks tighten policy. The positives are that EM

equities are cheap relative to developed markets and [Chinese technology stocks have already fallen significantly](#) in response to the regulatory crackdowns. EM equities could do well if there is significant stimulus in China early in the year, the Fed stays on hold and the U.S. dollar weakens. This scenario is possible but otherwise EM asset classes face headwinds heading into 2022.

The U.S. dollar has strengthened through 2021 on market expectations that Fed rate hikes are becoming more likely. It should weaken as investors realise the Fed is likely to remain dovish as inflation risks decline. Dollar weakness should support the performance of non-U.S. markets, which will help offset some of the headwinds facing emerging markets.

Risks: inflation, China, lockdowns

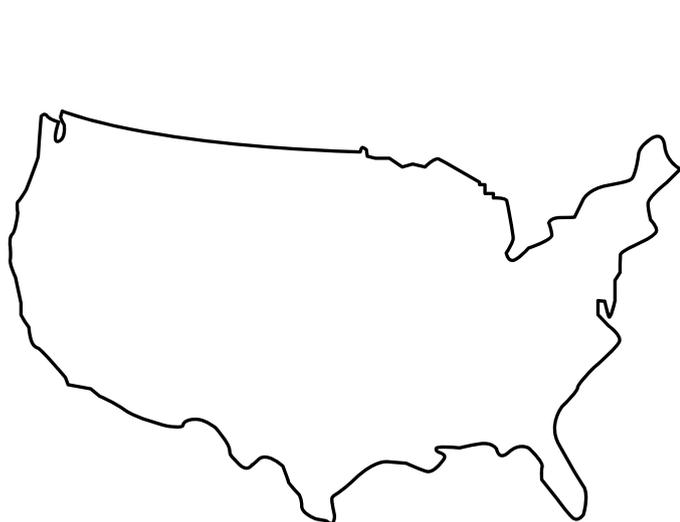
Inflation tops the list of concerns heading into 2022. We still expect it will prove mostly transitory, but this may not be apparent until the middle of the year. China is a significant downside risk for global growth. Policy announcements and credit trends will be important watchpoints over coming months.

COVID-19 refuses to disappear as a risk. New variants that are resistant to current vaccines are the main threat. We don't yet know [the implications of the omicron variant](#), but it highlights the uncertainty that exists around COVID-19 scenarios. Markets will be volatile around news of rising COVID-19 cases.

There is another risk to be considered: a much stronger-than-anticipated surge in demand if COVID-19 fears prove unfounded. Households have plenty of savings, there is pent-up demand, surveys point to strong business investment intentions and real borrowing rates are negative. We have a low probability on this outcome, but it would be double-edged if it occurred. There could be a blow-out rally in equity markets, but there would also be significant Fed tightening which would threaten an earlier end to the economic cycle.

Market and economic outlook:

Regional snapshots



United States

The U.S. economy is poised for a year of moderating but significantly above-trend economic growth in 2022. Robust household income and accumulated pandemic savings leave the consumer in a position of strength heading into the new year. We expect robust business investment in 2022, particularly as a record earnings recovery and backlogs align the ability and need to invest for corporations.

The biggest incremental drag next year comes from fiscal policy. Even if President Biden's Build Back Better full infrastructure package is passed, its per-year stimulus impact pales in comparison to the lumpy COVID-19 rescue bills in 2020 and 2021. All in, we expect the U.S. economy to deliver 4% real GDP growth in 2022.

Inflation remains a focus for investors. Moderating demand, rebalancing demand (from goods to services), and a healing supply side of the economy should allow U.S. inflation rates to throttle down aggressively in the second half of 2022. Elevated wage inflation and exceptionally strong labour demand are the key risks to this forecast. Fixed income markets have latched onto the higher inflation theme and now price a 98% probability of Fed liftoff in 2022. We think the risks are skewed toward a later liftoff and, eventually, a higher equilibrium interest rate than currently priced. If this is correct, the U.S. yield curve has the potential to re-steepen modestly, and the 10-year U.S. Treasury yield can end the year near 2%.

Eurozone

The Euro area heads toward 2022 with healthy growth momentum. Business surveys show broad-based gains across countries and sectors, and fiscal policy looks set to provide persistent support to growth as the EU recovery fund disbursements pick up and [Germany's new center-left traffic-light coalition government](#) pursues a more supportive fiscal stance. The European Central Bank remains firmly dovish in its policy outlook. We expect European GDP growth will slow in 2022, but should still be over 4%, significantly above the pre-COVID-19 trend rate of 1.4% per annum.

The main near-term risk is the November COVID-19 outbreak that has triggered renewed restrictions in northern Europe, particularly Austria, Germany, and the Netherlands. Vaccination rates are high and containment measures should be targeted and regional. There is a risk, however, that growth slows over the winter months.

The MSCI EMU Index, which reflects the European Economic and Monetary Union, has potential to outperform in coming quarters. Europe's exposure to financials and cyclically sensitive sectors such as industrials, materials and energy, and its relatively small exposure to technology, should benefit these markets as delta variant fears subside, economic activity picks up and yield curves steepen.

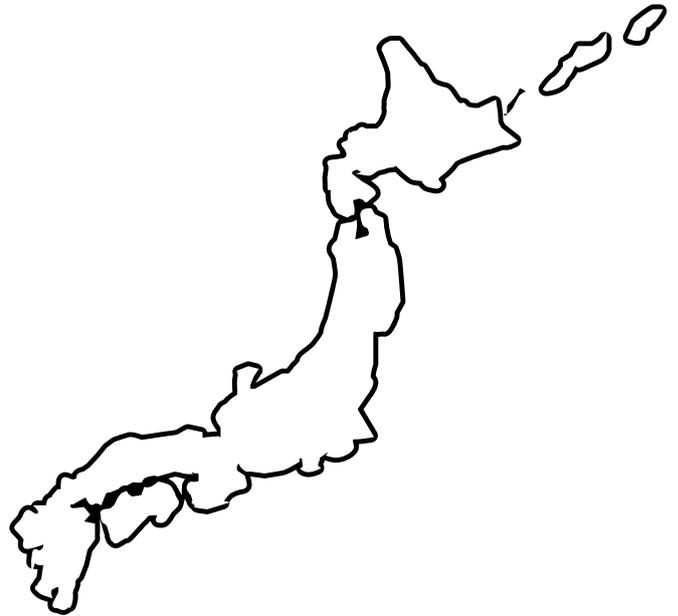


United Kingdom

The UK looks likely to achieve another year of above-trend GDP growth in 2022, although slower than 2021. The more rapid rollout of vaccine booster shots means the UK is better placed to cope with COVID-19 outbreaks than elsewhere in Europe.

Brexit, however, has placed constraints on labour supply and this is putting upward pressure on wages and inflation. It is also encouraging the [Bank of England \(BoE\) to begin lifting interest rates](#). Markets are priced for rates to begin rising in February. Senior BoE officials have warned of inflation risks, making an early rate hike likely. Declining inflation during 2022 as supply constraints ease should, however, convince the BoE to act cautiously.

UK equities have lagged the global rally in 2021. Sector composition continues to be a headwind, and the technology exposure of the FTSE 100 Index is amongst the lowest of developed markets. The index is the cheapest of the major developed equity markets and offers a dividend yield of close to 3.5% as of November 2021. It has the potential to outperform in a global cyclical rally as fears around inflation and COVID-19 ease.



Japan

The Japanese recovery remains lackluster, with consumption still below pre-COVID-19 levels. Looking to 2022, we should see some acceleration in economic activity. Consumers are sitting on excess savings, and the catch-up in vaccination rates will encourage more mobility and spending. The recently elected government of Prime Minister Fumio Kishida has announced a supplementary fiscal package of around 5.5% of GDP, which will flow through the economy in 2022. A pick-up in business confidence, and the structural challenges with an ageing demographic, should see businesses increase investment.

Unlike other countries, inflation has remained very subdued in Japan, due to softer demand and fewer challenges with supply chains. We expect a very modest pick-up in inflation through 2022 given import prices have been rising. However, this should not pose a challenge to the Bank of Japan, which will likely lag other central banks in raising interest rates.



China

We are cautious on the [outlook for China in 2022](#). The risks around the property market and the drag on the economy from construction has grown. The Chinese government has recently announced initiatives that have reduced the likelihood of the worst-case scenario by further ringfencing the risks around property and encouraging mortgage demand. This is a key watchpoint over coming months.

COVID-19 outbreaks will continue to present a risk to the economy until at least the 2022 Winter Olympics in Beijing, given the maintenance of the 'zero tolerance' approach to infection outbreaks. Regulation on the large consumer technology companies remains an uncertainty. We expect further fiscal stimulus through 2022 focused on boosting household consumption, but it will unlikely be large enough to offset the drags from property market downturns.



Canada

Strong domestic demand, a positive global business cycle, and firm commodity prices create the conditions for above-trend growth for the Canadian economy in 2022. We think GDP growth could be around 3.8%. We are less convinced that the Bank of Canada (BoC) will hike as much as the markets are pricing. The net effect should be modestly higher bond yields, a strengthening Canadian dollar, and positive returns for domestic equities.

The BoC is focused on a tight labour market and uncomfortably high inflation. It has ended quantitative easing and is now preparing markets for a mid-2022 rate hike. We are not convinced the BoC will hike as much as markets are pricing: roughly five hikes, lifting the target rate to 1.5% by the end of 2022. Two hikes seem more likely, keeping the BoC more in line with the Fed.



Australia and New Zealand

The Australian economy should pick up through 2022 as the country reopens after the sustained lockdowns through Q3 and early Q4 of 2021. Consumers still have excess savings, and there remains a large amount of pent-up demand for domestic travel. Australia has not seen the same levels of wage pressure as other regions, with many employers waiting for the re-opening of the borders and the return of the migrant flow of workers. This should give the Reserve Bank of Australia (RBA) breathing room from having to raise rates, and we think a rate rise is unlikely through 2022. The Australian dollar (AUD) is close to fair value on purchasing power parity, and we expect the AUD has some upside given traders are very negative on the currency.

The New Zealand economy should see robust growth through 2022 with the eventual re-opening of international borders boosting export demand. The political will to undertake sharp lockdowns remains higher in New Zealand than many other countries, which will remain a risk – but the seasonality of the next couple of months plus the pick-up in vaccination rates are encouraging. The Reserve Bank of New Zealand continues to run ahead of other developed central banks in raising interest rates on inflation concerns amid a labour market that has more than fully recovered. We expect further rate hikes from the RBNZ through 2022, which will prove a headwind to the housing market.



The U.S. yield curve has the potential to re-steepen modestly, and the 10-year U.S. Treasury yield can end the year near 2%.

Andrew Pease

Asset-class preferences: Outlook on stocks, bonds and currencies

Our cycle, value and sentiment investment decision-making process as of late 2021 has a moderately positive medium-term view on global equities. Value is expensive across most markets except for U.K. equities, which are near fair value. The cycle is risk-asset supportive for the medium-term. The major economies still have spare capacity, while inflation

pressures appear mostly transitory and caused by COVID-19 related supply shortages. We think rate hikes by the U.S. Fed are unlikely before 2023. Sentiment is moderately overbought, but not close to dangerous levels of euphoria.

Composite contrarian indicator shows sentiment as moderately overbought



Source: Russell Investments.
Last observation: 29 November, 2021.
Contrarian indicators for investor sentiment give a numeric measure of how pessimistic or optimistic market actors are through time.



We prefer **non-U.S. equities** to U.S. equities. Above-trend global growth and steeper yield curves should favour undervalued cyclical value stocks over expensive technology and growth stocks. Relative to the U.S., the rest of the world is overweight cyclical value stocks.



Emerging market equities will remain under pressure from the China slowdown and central bank tightening across other EM economies to contain inflation pressures. EM equities could do well if there is significant China stimulus early in the year, the Fed stays on hold and the U.S. dollar weakens, but otherwise face headwinds heading into 2022.



High yield and **investment grade credit** are expensive on a spread basis but have support from a positive cycle view that supports corporate profit growth and keeps default rates low.



Government bonds are expensive, and yields will face upward pressure as above-trend growth closes output gaps. We expect the U.S. 10-year Treasury yield to rise toward 2% over 2022.

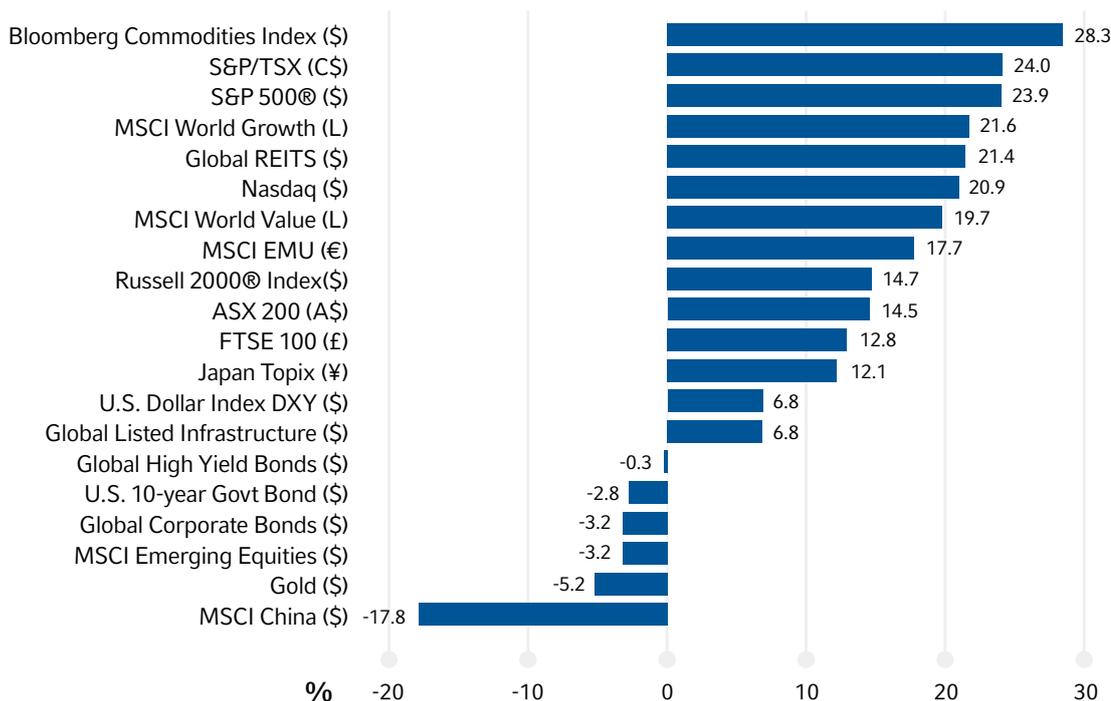


Real assets: Real Estate Investment Trusts (REITs) have significantly outperformed Global Listed Infrastructure (GLI) so far this year, to the extent that REITs are now expensive relative to GLI. Both should benefit from the pandemic recovery, but GLI has some catch-up potential. GLI should benefit from the global recovery boosting transport and energy infrastructure demand. Commodities have been the best-performing asset class this year amid strong demand and supply bottlenecks. The gains have been led by industrial metals and energy. Commodities should retain support from above-trend global demand, but the slowdown in China limits upside potential.



The **U.S. dollar** has been supported by expectations for early Fed tightening and U.S. economic growth leadership. It should weaken as global growth leadership rotates away from the U.S. and as expectations for early Fed tightening are unwound. The main beneficiary is likely to be the euro, which is still undervalued. We also believe **British sterling** and the economically sensitive commodity currencies—the **Australian dollar**, **New Zealand dollar** and **Canadian dollar**—can make further gains. We think the **Japanese yen** has upside potential given its undervaluation and supportive real yields. Sentiment is also a positive with investors crowded into short yen positions.

Asset performance since the beginning of 2021



Source: Refinitiv® Datastream®, as of 26 November, 2021. (L) implies local currency.



Above-trend global growth and steeper yield curves should favour undervalued cyclical value stocks over expensive technology and growth stock.

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