THE GREAT MODERATION

Russell Investments

2022 Global Market Outlook

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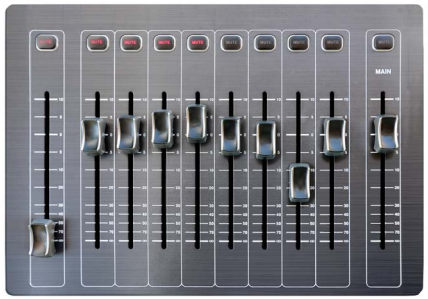
Synopsis



We believe global growth will be slower in 2022 than 2021, but still above trend. Amid this backdrop, we think equities should outperform bonds. In addition, while inflation has yet to peak, we believe it will likely decline over the year. As a result, we expect any tightening by central banks in 2022 will be modest.

Key market themes

2021 was a year of rebound and recovery, and we expect that 2022, by contrast, will be a year of moderation—particularly when it comes to 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. Overall, the global economy appears poised for a second year of above-trend growth, but at a slower pace than in 2021. In our view, the three main uncertainties for 2022 are:

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

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

Our cycle, value and sentiment (CVS) investment decision-making process continues to score global equities as expensive, with the U.S. the most expensive developed equity market globally. We see the business cycle as still supportive for equities, while becoming a larger headwind for government bonds. In the U.S., we believe that moderating demand, coupled with a rebalancing in demand (from goods to services) and a healing supply-side of the economy, should allow inflation rates to throttle down aggressively in the second half of 2022. We also think rate hikes by the U.S. Federal Reserve (Fed) are unlikely before 2023.

We expect Europe to head into 2022 with healthy growth momentum, with business surveys showing broad-based gains across countries and sectors, and fiscal policy set to provide persistent support to growth. We believe that the MSCI EMU Index, which reflects the European Economic and Monetary Union, has the potential to outperform the S&P 500® Index in the coming quarters.

In the UK, Brexit has placed constraints on labour supply, putting upward pressure on wages and inflation. The situation is encouraging the Bank of England to begin raising interest rates, with markets priced for liftoff in February. While UK equities have lagged the global rally in 2021, the FTSE 100 Index is the cheapest of the major developed equity markets and offers a dividend yield of close to 3.5% as of November 2021. We believe it has the potential to outperform in a global cyclical rally as fears around inflation and COVID-19 ease.

China's 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 (gross domestic product) seems in the ballpark, according to various estimates. 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.

In Japan, inflation has remained very subdued, due to softer demand and less challenge with supply chains. We do expect a very modest increase in inflation through 2022, given that import prices have been rising. However, this is unlikely to pose a challenge to the Bank of Japan, which we believe will lag other central banks in raising interest rates.

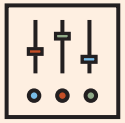
Economic growth in Australia should pick up through 2022 as the country reopens following sustained lockdowns during the second half of 2021. Because Australia has not seen the same levels of wage pressure as other regions, we believe the Reserve Bank of Australia will likely hold on raising rates through 2022.

We foresee above-trend growth in Canada in 2022, but are less convinced that the Bank of Canada (BoC) will hike as much as markets are pricing. We believe the more likely outcome from the BoC in 2022 is two rate increases, rather than the five markets are penciling in.

Economic views

U.S. GROWTH

We believe that the U.S. economy will deliver 4% real GDP growth in 2022.



CHINA SLOWDOWN

We expect China's GDP growth rate will slow to under 5% in 2022.

EUROPEAN GROWTH

We believe Europe's exposure to financials and cyclically sensitive sectors—including industrials, materials and energy—gives it the potential to outperform as economic activity picks up and yield curves steepen.

U.S. EMPLOYMENT

We believe that the U.S. is unlikely to achieve *maximum employment*—or an unemployment rate of 4%—until the end of 2022.

10-YEAR TREASURY OUTLOOK

We expect the 10-year U.S. Treasury yield to rise to around 2% by the end of 2022.

Asset class views

Equities: Preference for non-U.S. equities

We believe 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.

Fixed income: Government bonds expensive

We expect government bond yields will face upward pressure as above-trend growth closes output gaps. 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.

Currencies: U.S. dollar likely to weaken

The U.S. dollar has been supported by expectations for early Fed tightening and U.S. economic growth leadership. We believe it should weaken as global growth leadership rotates away from the U.S. and as expectations for early Fed tightening are unwound. We think that 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, the New Zealand dollar and the Canadian dollar—can make further gains. We think the Japanese yen also has upside potential, given its undervaluation and supportive real yields. Additionally, sentiment is a positive, with investors crowded into short yen positions.

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