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December 2021

ECONOMIC INSIGHT

2022 Economic Outlook

Most advanced economies have seen peak growth, but there remains an expectation that above trend growth rates will continue in 2022. Policymakers have the unenviable task of now guiding the transition to a new normal with a focus on fixing supply-demand imbalances and working to see both inflation and unemployment fall. There is little room for error. Asset markets will need to cope with both the implications of policy normalisation and slowing growth rates that will weigh on returns. Uncertainty remains elevated, not least because of the appearance of the Omicron variant that presents considerable downside risks to the outlook.

As we write, the new Omicron variant of COVID-19 is reverberating through markets and the impact on markets and economies is highly uncertain. It is an open question as to whether this will be a less harmful variant that can be addressed within current parameters and vaccinations, or a more virulent strain that is a greater threat to public health. The latter would likely result in ongoing risk-off moves in markets as they anticipate renewed restrictions that would lower growth and foster even more inflation, and potentially more policymaker action.

Growth beyond the recovery

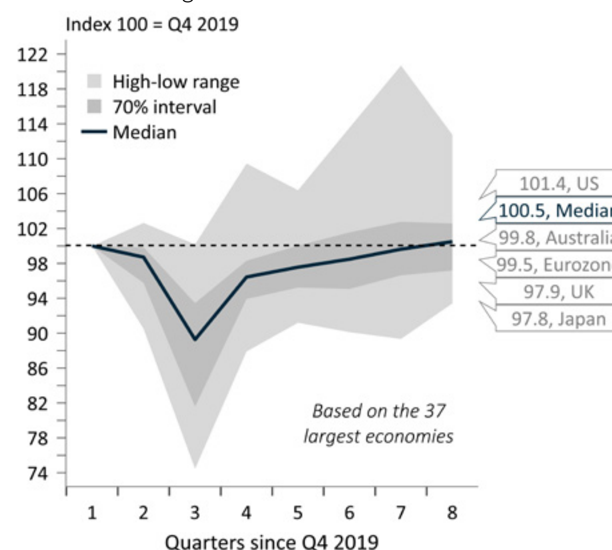
In 2021, the global economy rebounded as expected from the pandemic-induced recession of 2020. However this strong global rebound masks considerable deviation in recovery strength between individual economies that has been highly dependent on vaccination rates and the lifting of restrictions that held back economic activity. This is illustrated by the fact that at the mid-point of 2021, 21 of the 37 largest economies globally had still not recovered to pre-pandemic levels of output.

While most advanced economies are past 'peak-rebound', there is an expectation that above trend rates of growth will continue in 2022. And in this environment, policymakers are seeking to make the transition to a new normal for economies while fixing demand-supply imbalances to see inflation decelerate and unemployment rates fall too – a herculean task to get everything just right. And all this will only be possible based on the assumption that there is no material setback that stalls the winding back of public health restrictions.

This is a highly uncertain point, with the Omicron variant now emerging, but we are assuming that this

GRAPH 01 REAL GDP SINCE Q4 2019 GLOBAL

All are recovering but some better than others



Source: IFM Investors, Various national statistical agencies, Macrobond

variant can be better managed than previous ones, given relatively high vaccination rates. Should this be the case, growth will continue to be underpinned by the fiscal and monetary accommodation still in place. And thanks largely to the former, combined with restricted ability to spend on services, the material build-up of cash on private sector, particularly household, balance sheets. This growth will likely be characterised by a swing back to spending on services rather than goods (particularly as global travel resumes), and facilitated by the dramatically reduced, but not resolved, friction in global supply chains. But we remain sceptical that economies will outperform pre-pandemic trends over coming years.

One of the reasons for this is that both monetary and fiscal stimulus are being reversed simultaneously. The key growth driver from fiscal stimulus - cash on household balance sheets - will wane relatively quickly in our view. The focus of fiscal stimulus was flows from governments to households whose spending then benefited corporates. But it remains to be seen if this will translate into a sustained uplift in investment (particularly outside of that embedded by the structural demands of climate change). That leaves just public investment, but with debt burdens having become significantly larger, we suspect a material expansion in this space will not be forthcoming, with the notable exception of the relatively long-dated US infrastructure plan.

Of course this then leaves productivity, and while improvements in productivity may be prioritised in the wake of the pandemic, to our long-standing lament, governments are unlikely to push through any aggressive reformist agendas. Here we can quote our own words from last year's Q4 missive as the words still ring true: "*Economies will eventually recover from this crisis, but they clearly won't be 'better', nor ready to face future setbacks in the near term*".

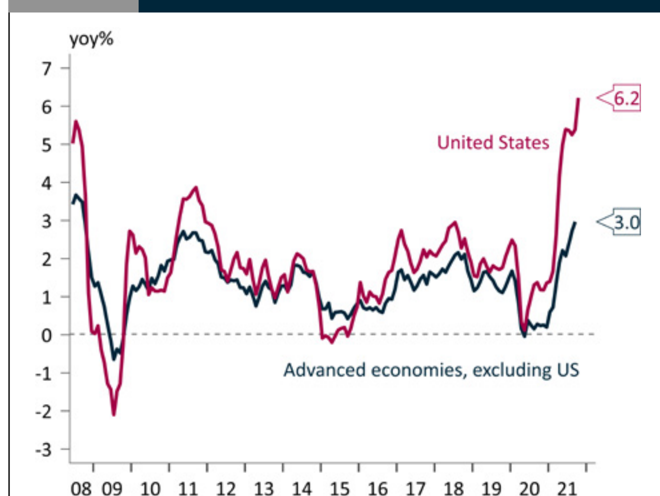
Inflation on the rise

While growth did not surprise in 2021, inflation certainly did. The degree to which it decelerates over the course of 2022 will be a key determinant of the stance of global monetary policy. What is clear is that the word 'transitory', a mainstay of the 2021 central bank lexicon, has itself proved transitory in terms of its usefulness to describe inflation.

Price pressures have been far more persistent than expected as fiscally-fuelled demand was combined with pandemic-induced supply constraints. Most believe the latter will clear as the health crisis abates, supply chains both in producer and consumer countries improve (in terms of production and logistics) and supply responds to price signals. But that will remain a matter of faith as policymakers' ability and proactivity to remedy these issues remains questionable.

The risk is that the deceleration of inflation occurs at a measured pace. In those countries and sectors in which wage growth has not kept pace, this will act as a near term headwind to growth as consumers face permanently higher prices (no one is expecting the spike in inflation to unwind completely).

GRAPH 02 US AND AE CPI



Source: IFM Investors

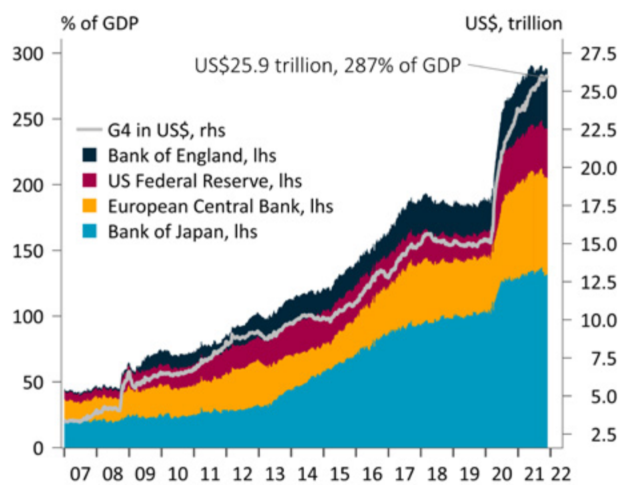
The unenviable task of central banks

So far the major central banks have held their collective nerve and sought to 'look through' supply side inflation that they have little influence over. We believe this has been the correct course to take, as adjusting policy to meet it would clearly risk economic recoveries and the key objective of labour market repair. The word 'stagflation' has been re-popularised but in the stricter sense of the concept - high and rising inflation and unemployment and weak growth - it has been overplayed. The greater risk appears to be slower growth and less pronounced labour market repair, and central banks seeking to address current inflationary pressures would only exacerbate this risk. Such an eventuality is counter to the objective of all central banks, which is to generate sustainable, near target inflation, spurred by the demand side and the Phillips curve.

From our perspective, the challenge for central banks will be to calibrate policy as economies transition from the "inflation that must be tolerated" (and inflation expectations managed) to the "inflation that is desired". This is particularly true as it becomes even more difficult to differentiate between the two once indirect effects flow through. It is a new paradigm for them. After spending the years before the pandemic setting policy to get inflation to accelerate, they are now trying to get inflation to decelerate and have a soft landing as their targets.

On the basis of the current inflation outlook, our expectation is that in the first half of 2022 developed economy central banks will seek to draw to a close the emergency and largely quantitative policy settings employed to address the economic impact of the pandemic. Although we believe that current market pricing for rate hikes is overdone in terms of timing and magnitude, we do expect to see the early stages of what will be a cautious path of policy normalisation. The Bank of New Zealand has already begun this process and the Bank of England (BoE) is widely tipped to lift its policy rate later this month. Of the majors, the US Federal Reserve (Fed) is likely to be the first to raise rates early in the second half of 2022, with the European Central Bank (ECB) and Bank of Japan (BoJ) content to let the Fed go it alone, adjusting only non-interest rate

GRAPH 03 CENTRAL BANK BALANCE – INDIVIDUAL



Source: IFM Investors

policy over the course of the year. We expect the Reserve Bank of Australia (RBA) to also fall into this category.

Market implications

For asset markets, the challenge will be to cope with the passing of peak policy stimulus and the speed at which that stimulus is removed, particularly in the US. This will occur as economies move from the outright recovery phase of the economic cycle to a broadly expansionary one which is characterised by already elevated levels of inflation. In this environment, equities should continue to do relatively well in 2022, yet not as well as 2021 when headwinds were still limited. As this year comes to a close, equity market valuations appear stretched, particularly in the US. Fundamental drivers, such as company earnings, will need to keep on delivering in economies in which stimulus is fading. This may be possible in the nearer term, but it may be challenged if economic growth underperforms expectations.

The removal of monetary stimulus, however gradual, will keep fixed income returns under pressure. It remains uncontroversial to be underweight government bonds from a strategic perspective. But investors will likely take tactical positioning around duration across jurisdictions as global central banks decouple their policy settings.

In the credit space, the extreme compression of both investment grade and high yield spreads will likely continue to gradually unwind to levels that prevailed, on average, pre-pandemic. This should occur as central bank quantitative easing (QE) purchases are wound down and corporate issuance is expected to remain strong. This view assumes no material rise in corporate stress, with economic conditions supportive and balance sheets solid.

We expect to see some paring back of overweight positions in global equities and investors remaining underweight the bulk of the fixed income space. However, real assets continue to look attractive. This reflects investors looking for additional returns by edging up the risk curve and the supportive macroeconomic backdrop. Over the course of the coming year, infrastructure offers an attractive hedge against elevated rates of inflation. We observe this directly via our own global infrastructure portfolio which has a positive inflation 'beta'.

Further, in previous cycles inflation would have been preceded or accompanied by central banks tightening monetary policy that would push up risk free rates. However, this is not the case in this cycle. Inflation has come first and central banks are seemingly content to remain cautious. While we do not expect real rates to stay at or near record lows, we believe they may stay low, and possibly negative for some time yet, serving as a tailwind to the infrastructure sector. We also believe the sector benefits from the dynamics of reopening economies, given strong GDP linkages. For example, strong demand for goods has lifted port volumes materially higher, particularly in jurisdictions that have been able to get goods supply. Another late cycle example is the rebound in airport traffic that should gather momentum through the course of 2022 as international border restrictions ease.

Key risks for 2022

While the expansionary phase of the cycle should continue in 2022, geopolitical and domestic policy risks will likely bubble away through next year with potentially material impacts on markets and economies. Key among those that are known are:

- **A reversal of improving pandemic conditions** - This is not to be underestimated given several European countries are currently facing at least some reintroduction of restrictions due to case numbers rising despite relatively high vaccination rates. As we noted earlier, the emergence of the Omicron variant of COVID is a developing story currently around which there is little certainty. The outlooks canvassed in this piece are all highly dependent on this being resolved with aggressive prolonged restrictive public health measures being unnecessary.
- **US-China trade tensions** – These tensions remain, despite a lull in antagonistic rhetoric on both sides through the pandemic and with the change in the US administration. By contrast, China's deteriorating relationships with middle-powers will continue to drift, with particular risks for Australia. US-Iran discussions about nuclear capability have scope to reignite regional tensions, with likely consequences for oil prices.
- **US mid-term elections** - History has shown that incumbent Presidents lose support at the mid-terms and as it stands the poor approval ratings of the Biden Administration mean the 2022 mid-terms will likely be no different. This may create uncertainty with regard to the passage of fiscal stimulus and the debt ceiling.
- **European elections** – There are several during the year, with Presidential races in France and Italy being key, given the potential for them to set the post-Merkel tone in the region (along with the fledgling German coalition government elected in 2021).
- **Brexit-related risks continue in the UK** – There is a nontrivial risk that Article 16 of the Northern Ireland protocol is triggered, a signal that trade tensions between the UK and Europe will continue for some time to come.

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IFM-09DECEMBER2021-1946052

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