BARINGS

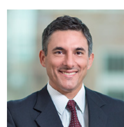
— 2022 OUTLOOK —

THE NEW NORMAL COMES INTO VIEW

Economic Outlook Roundtable

The global economic recovery looks set to continue in 2022, but a number of risks remain—from tangled supply chains to lingering price pressures. Join our panel of experts as they explore these issues from both the "top-down" and "bottom-up."

Christopher Smart (Moderator)
Chief Global Strategist & Head of the Barings Investment Institute



Ricardo Adrogué
Head of Sovereign Debt and Currencies

James Leung
Head of Multi-Asset Asia Pacific

Alexandra Hillier
Head of Global Health Care, Equities

Christopher: While there are still plenty of uncertainties and unknowns ahead, the pandemic seems more contained in developed markets versus a year ago. Alexandra, talk us through the patterns in developed and emerging markets in terms of the rollout of vaccines and the risks that we may see further lockdowns.

Alexandra: In the absence of the emergence of a new variant that has significantly higher levels of immune escape, we believe the risk of extensive and prolonged lockdowns in developed markets is still fairly low, as we now have a relatively high percentage of populations vaccinated. The picture in emerging markets is less clear. We have enough capacity in 2022 to vaccinate the world, but there are some bottlenecks in terms of distributions and getting jabs into arms. In markets where the virus has been spreading for some time, we're reaching some form of herd immunity.

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Christopher: Ricardo, what do you think about the momentum going into next year for global demands as governments consider withdrawing their support both on the monetary and fiscal side?

Ricardo: The U.S. Federal Reserve (Fed) has said they have effectively met the inflation objective of the dual mandate, so we are going into 2022 with self-sustaining growth, which is very good for the global economy and the emerging market space. But at the same time, we're having some retrenchment of monetary accommodation. Indications from key policy makers, especially in the developed world, suggest accommodation will not be withdrawn drastically, which could give emerging markets time to either fully vaccinate or make significant progress in the battle against COVID like the developed markets have.

Another positive, and one that tends to be overlooked, is global trade is growing quite briskly after lagging from 2008 through 2020, which is supportive of both the world economy and emerging markets.

Christopher: Emerging markets have struggled this year, in part due to the fact that the rate expectations in the U.S. have picked up and the dollar has been strong. Will those headwinds persist next year?

Ricardo: Most likely, yes. But it's important to note that within the emerging markets space, there is tremendous variation from country to country. We have countries with economies that are similar to developed markets, many of which have the ability to borrow from their very deep domestic markets. And then there are smaller economies that are more dependent on external funding. These countries tend to get hit harder in every crisis—the pandemic was no exception—and may continue to struggle next year amid inflationary pressures.

Christopher: James, you live in Hong Kong, one of the most important links in the world's supply chains. How well has trade returned to normal, and what disruptions are we going to see in the months ahead?

James: It is a global issue and it's quite evident in Asia as well. Although trade activity in China has been encouraging, with strong shipments to developed markets including the U.S. and Europe, bottleneck constraints remain high. Some of the increases in nominal exports are surely owed to steep price increases. But over the next few quarters, we expect COVID-related backups at some Chinese ports to fade. In Japan, auto-related firms are pointing to production cutbacks from persistent semiconductor shortages and noted difficulties in getting parts from Southeast Asia. So that problem is not going away any time soon.

Christopher: Beyond port capacity, there are other factors investors are focusing on in your part of the world. How serious are headwinds such as regulatory enforcement, property disruptions, or electricity shortages for the Chinese economy?

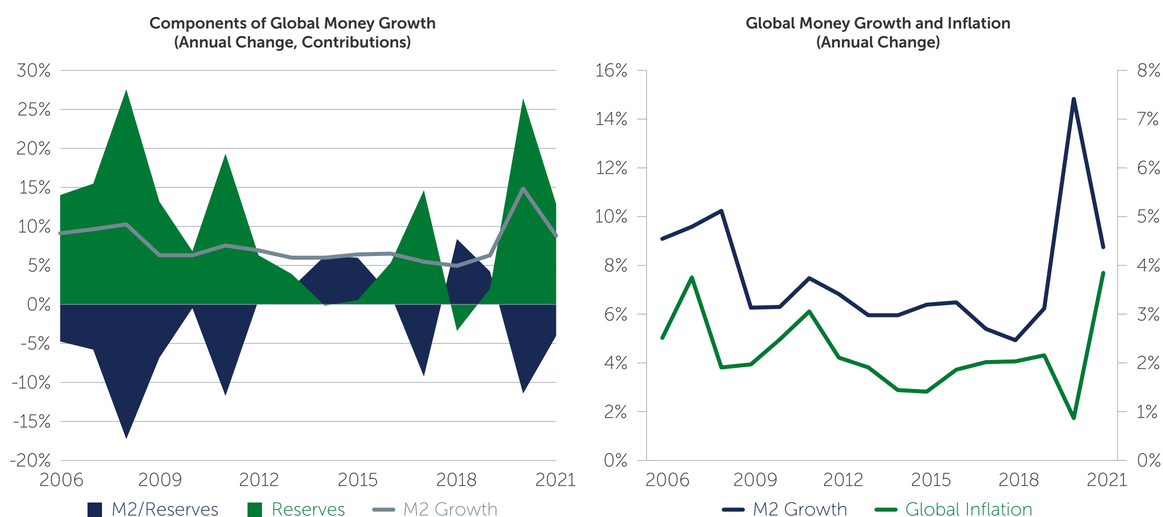
James: The property downturn has weakened fixed asset investment, and the zero-COVID policy certainly inhibits consumption recovery. But if GDP growth slows sharply in the coming months, we expect some sort of easing from the government in terms of fiscal and monetary policies to support growth—and, more importantly, to prevent a property-led hard landing. As an example, the recent PBOC announcement of the new green lending tool is a first step toward targeted easing to offset the downward pressure on growth, at least in the short term, which could also help achieve the longer-term goal of decarbonization. Combined with anticipated targeted easing measures in other areas, we hope to see some sort of engineered modest recovery in Chinese growth next year and, in the broader sense, we're expecting uneven global growth next year.

Christopher: Ricardo, it is a complicated picture as there's both tightness and slack in the global economy. Are you worried about lingering inflation?

Ricardo: We like 10-year and 30-year bonds, and those shouldn't be affected by near-term inflation, as in two to three years. Near-term inflation is very strong, and we think the trends that caused interest rates to come down for so long—primarily demographics, and the reduction in births that is causing declining population growth—are still in place.

Something that is typically not talked about is quantity of money. In this case, we're focusing on money aggregate M2, which is basically the sum of deposits (created by commercial banks) plus reserves (created by central banks). We're going into the next year with the view that central banks have realized they're creating too much money. In 2009, banks undid almost everything that central banks did. Central banks created roughly 25% extra money, and banks took out about 20% of that. So the money creation went to about 5%, and there was no inflation. In 2021, we had central banks creating 26% extra money, but—because the pandemic wasn't a financial crisis—banks didn't take out as much, only about 10%.

Figure 1: Beware of Quantitative Easing (QE) Removal



Sources: Haver Analytics; Bloomberg; Barings estimates.

Now, we have central banks retrenching their QE, reducing the pace of reserves, and beginning to talk about taking reserves out of the system. We need commercial banks to create money, M2. Otherwise we will certainly go back to pre-pandemic trends, which were for lower inflation and very low interest rates.

Christopher: James, from your perspective, what is it that you're most worried about in terms of inflationary pressures?

James: Many firms have been able to protect margins with very strong pricing power, at least for the moment. That's good for corporate profits, but the concern that consumers are starting to build-in inflation expectations is actually quite valid and worrisome. Given still-healthy profit margins, a company should be eager to ramp up the production as soon as supply normalizes, which will help ease price pressure eventually. However, it does take time for the market to find a new equilibrium, so I expect firm prices to be extended through at least the first half of next year.

Christopher: James, you mentioned equities look particularly good as you put together a multi-asset portfolio going into next year. What other areas are you keeping a closer eye on?

James: Multi-asset investing is never easy and it's getting more challenging every year. We go back to the basics of investment cycle investing, whereby style selection gives us a clearer signal. Since we are past the peak of economic growth in most developed economies, stocks that exhibit quality and growth styles, in our opinion, are the best when growth moderates, which we think it would, over the next year or so. Our portfolios are already tilted this way, and I expect the style positioning to work well into 2022.

We still prefer the U.S. given its earnings visibility and high exposure to technology companies. We see the Japanese market having potential to catch up with other developed markets, with the reopening complemented by a strong earnings rebound, ongoing expansion, monetary policy, and potential sizable fiscal stimulus, which should be quite supportive for domestic equities from a top-down perspective.

Christopher: Ricardo, you look at sovereigns in the developed world, as well as the emerging world, and currencies globally. What opportunities do you expect to focus on next year?

Ricardo: The biggest opportunities seem to be within the credit space, particularly BB sovereigns. Of course, there are certain single-B countries that are putting up a very good fight, and we think they will also do well. But broadly speaking, BBs seem to be better-positioned. There also seem to be some opportunities in local rates, since interest rates in emerging markets have not followed the path of developed market rates. For instance, for countries like Mexico, Russia, Brazil—which have seen a similar range of inflation as some developed markets—interest rates have not moved. And finally, currencies continue to look cheap relative to history, presenting potentially attractive opportunities.

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