2022 Global Multi Asset Outlook: Gauging long-term growth prospects

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By the Multi-Asset Team

Long-term prospects for growth remain on firm footing

The year 2021 was marked by the ebb and flow of COVID-19 waves as well as rising inflation, which was partly a manifestation of supply chain bottlenecks, but also partly a function of rising demand as stimulus continued to be ample. Meanwhile, the Federal Reserve (Fed) has shifted its policy to target average inflation, meaning that it is willing to let inflation overshoot in the short term on the premise that the long-term average will fall closer to its 2% target. With inflation printing at the highest levels in 30 years, coupled with a somewhat unknown determinant of what portion is transitory, markets are left to speculate on a very uncertain path to policy normalisation.

The removal of extraordinarily easy policy is always prone to increased volatility, but the bottom line for final demand and growth is whether policy remains accommodative. It does remain accommodative, and it is likely to remain so for some time. Still, given the distortions in the rates markets, it is less clear which risk assets will pay off in the coming 12 months. The US yield curve is abnormally flat, implying a fast pace of near-term rate hikes. At the same time, low long-term rates suggest disappointing long-term growth under the same premise that the Fed will need to raise short-term rates quickly, thereby stifling growth.

Rates markets ordinarily work well for predicting imminent Fed policy changes. But current speculation is far into the future, and trying to see what's ahead in such conditions could be akin to looking into a crystal ball. Our central premise for more than a year is that long-term rates should rise. That it did in the first quarter of 2021, quite abruptly, feeding the reflation trade while punishing tech and other rich high-quality names. But after the US Treasury (UST) 10-year yield lifted from 0.91% to 1.74% in just one quarter, long-term rates lost their head of steam—trending down to 1.43% at the time of writing.

Still, we believe long-term rates should end higher before the Fed is done with their tightening cycle some time from now. Inflation looks to be less transitory than the Fed originally speculated, but it seems unrealistic to think that inflationary pressures are so endemic that it requires the Fed to deliver a crushing blow to the economy through an accelerated tightening cycle. Under this premise, the gradual rise in long-term rates should be beneficial to reflationary assets at the expense of secular growth where valuations look expensive.

A pivotal question on risk assets is what happens to the US dollar. Reflationary growth suggests a weak dollar, but if real rates in the US rise faster than in the rest of the world, this dynamic is a tailwind for the currency and a headwind to reflationary growth.

Of course, COVID-19 can change all the above, as we recently experienced—the volatility spike that closely followed the discovery of the Omicron variant was compounded by a Fed still convicted to accelerate the removal of quantitative easing. But very interestingly, this spike in volatility was not met with a concomitant lift in the dollar, which is rare. Over long time horizons, the dollar is not cheap, and it just may be stuck in a range set in 2015 after lifting over 20% due to the last Fed taper.

The bottom line is that while markets are speculating beyond normal limits of policy visibility in light of still high inflation prints mixed in with bouts of new COVID waves, the world is still learning to live with the virus and policy remains accommodative, which is supportive of risk assets. Importantly, China has turned dovish after a harsh year of regulatory crackdowns while maintaining tight policy. While finding the near-term inflection points for opportunity and risk will remain difficult, it seems the long-term prospects of growth have a reasonably firm footing.

The following are some of the key themes that we are currently monitoring for 2022:

- **Path of Fed normalisation:** Given the above-described challenges of rates markets perhaps going over their skis in terms of predicting future actions by the Fed, it is nevertheless important to understand the direction of rates, the dollar and ultimate impact on sentiment which can feed back into final demand. At present, we still see the Fed reducing stimulus gradually. That said, a fast step "autopilot" scenario reminiscent of Fed Chair Jerome Powell saying "we're a long way" from the neutral rate back in October 2018 when markets were beginning to crumble is a potential downside risk.

- **Watch the dollar:** Our long-term view is that the dollar should get weaker as global demand and growth improves, but the course to that endgame follows the uncertainty of the path to Fed normalisation. If the Fed remains firm in its resolve to remove easy policy to the extent that it threatens global demand—in effect, supporting the dollar—we suspect that the Fed would eventually back off as it did in December of 2018. Our base case is that the dollar will generally weaken, following the normalisation of global demand and growth.

- **Resolution of labour market supply:** Between the hesitancy to return to service-based jobs where human contact (and potential virus exposure) is a constant, and other late baby boomers opting to retire sooner, some dislocations in labour supply are bound to be lasting. If the productivity does not keep up, (yes, companies are investing, but are they investing enough?) will real wages rise to the extent that the Fed would feel compelled to tighten policy more quickly? If we learn to live with the virus and fear levels subside, extra supply can fill the gap, but this remains a critical question.

- **The government response to COVID-19:** We often say, "the world is learning to live with the virus", which is a euphemism for suggesting that new restrictions are generally expected to be lower than the last as people just get on with their lives. We were a bit taken aback when the discovery of Omicron with its headline-grabbing "more than 30 mutations" was enough to cause governments to restrict travel and in some cases implement local mobility restrictions, despite high vaccination rates. These actions appear less to be learning to live with the virus, but so far, our assessment is that draconian responses to any new variant will be limited.

- **Geopolitics:** We still believe that risk of a geopolitical flareup significantly affecting the markets is remote given the Biden administration's pragmatic approach to smoothing a path in dealing with China. Tensions are far from appeased, but likely gone are the days when a tweet can set off a firestorm of markets quickly recalibrating the extent of the potential damage. What about Russia? Ructions with Russia seem high at the moment, but the timing is inconvenient given the greater focus on China and the teetering energy crisis in Europe if all guns come blazing. While we suspect this recent crisis will find a normal resolution, it remains an important watchpoint.

- **Politics:** Needless to say, politics are increasingly divided in the US and in other nations. Mid-term elections are approaching in the US, and many analysts suggest that the Republican Party may regain some of its force in the House and/or the Senate as is often the case when the White House switches parties. Oddly, this dynamic is generally bullish for equity markets as efforts to bring more significant change are stymied and status quo is usually best from a market perspective.

On balance, amid significant uncertainty, we remain constructive on growth between: (1) the world learning to live with the virus as high vaccination rates outweigh the benefits of returning to restrictions on the latest variant, (2) China easing, which will lift global demand at the margin and (3) the gradual removal of easy policy where central banks are showing and are justified in remaining patient on inflationary concerns. The risk to this outlook is mainly the path of Fed policy, the normalisation of labour markets and how conducive governments are to return global sentiment to a normal path of learning to live with the virus.

Asset class outlook

Equities: The outlook for equities continues to be positive, given the still easy policy and the ongoing recovery of final demand. Still, markets are edgy, as always when the Fed's path toward removing easing policy is uncertain. This is the harder part of the cycle when equities have already returned to healthy valuations. The challenge will be finding the appropriate exposures depending on the pace of reflation and the direction of rates and the dollar. However, there are opportunities that extend outside of these rote mechanics—including in China equities. Given the tight policies in China—regulatorily, fiscally and monetarily—easing at the margin is a big plus in light of attractive valuations.

Sovereign bonds: In the developed market space, bonds still look expensive given our projections on growth and the more likely higher terminal cash rate as the Fed begins to lift rates. We like China bonds, particularly given the shift to easing there. We also like emerging market local currency bonds due to the fast pace in their markets to tighten to keep up with inflationary pressures, unlike those of developed markets. The wild card here is the dollar, as dollar strength will not be kind to emerging market local currency bonds. Even so, we like the risk-return payoff, and we stand ready to hedge currency risk if the dollar returns to strength.

Credit: Global credit usually makes sense when policy is still easy and growth is improving. The spread is tight, so the relative attractiveness of the asset class is less than it was in 2020, but the trade still makes sense until policy and/or demand looks tight. Of course, given the policy uncertainty and the relative tightness in spreads, volatility for this asset class is also likely to be elevated through the policy normalisation process.

Commodities: The asset class is a natural hedge to inflation risk, while also benefiting from improving demand. Performance over 2021 has been clouded by relatively tight China policy and bouts of dollar strength. Looking forward, easing in China is a tailwind for commodities, albeit not with the same strength as more aggressive easing campaigns in the past. The direction of the dollar is less certain but given our long-term bearish view on the dollar and improving global demand, we remain bullish to commodities.

Conclusion

We maintain a constructive view of risk assets but are cognizant that the path toward realising gains will be more delicate as we traverse the course of the Fed and other central banks removing their easy policies. The dollar should ultimately weaken given its still relatively rich valuations and the return of global demand, but its course is likely to be wobbly, adding to periodic risk off pressures. We prefer China bonds for their superior yield and defensive characteristics, particularly as the People's Bank of China begins to ease. We also like emerging market local currency bonds for their attractive yields and advanced state of tightening, but with the recognition that bouts of a strong dollar might require hedging. Credit is still interesting for the yield pick-up but less so for spread compression. Commodities also look attractive for their inflation hedging characteristics and positive beta to China easing and returning global demand.

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