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INVESTMENT MANAGERS

Perspectives

By James Beaumont & Nuno Teixeira, Natixis Investment Managers Solutions

2022 Outlook: The recovery continues in the near term

IN SHORT

- Although lower than in 2021, we expect growth to remain above its long-term target
- Inflation should broadly subside over the course of next year as supply-demand mismatches get resolved and labour market tightness eases
- We prefer to moderately overweight developed markets equities while keeping a short duration exposure in bonds

As we look to 2022, we find ourselves with a positive stance on growth as the US and Europe appear committed to avoid the austerity that led to the weak recovery following the Great Financial Crisis. As such, we see growth continuing to be strong in developed markets during the first half of the year, followed by a gradual normalization in the second half.

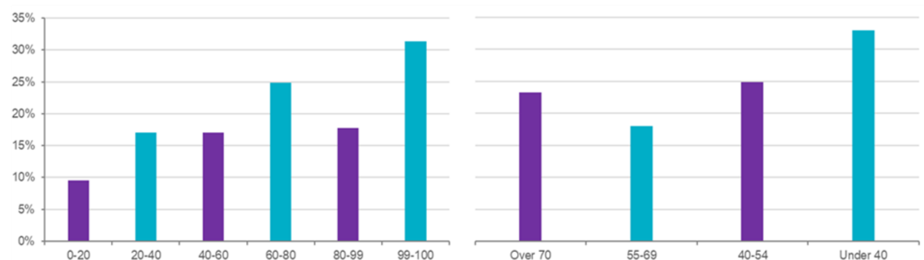
From pandemic to endemic

Although the pandemic is expected to fade in 2022, more but less severe outbreaks are likely as Covid transitions to an endemic disease. After almost two years dealing with the virus, policymakers and health authorities have gained very valuable experience in how to efficiently handle new outbreaks. In addition, ongoing vaccinations, new treatments, and the immunity gained from previous infection are likely to cap the risks for national health systems. Indeed, although localized restrictions may sometimes still be needed, we expect them to become more infrequent. Therefore, the virus should have a diminishing impact on economies and markets.

Macro scenario

Our 2022 economic scenario is based on growth continuing to be above trend during the first half of next year, especially in developed markets, as consumer spending remains particularly strong, supported by considerable excess savings accumulated during the several lockdowns. Since the start of the pandemic, US households' net worth has grown by 22%, which should continue to act as a strong tailwind for the economy. Data reflects that this increase in net worth has been relatively even across income percentiles and age brackets.

Change in Household Wealth in the US between Q4 2019 and Q2 2021 by Income Percentiles and Age



Source: US Federal Reserve, NIM Solutions.

In the second half of the year, we expect growth to normalize as the strong reopening comes to an end, excess savings are spent, and emergency stimulus measures are withdrawn.

The same is true for Europe as it is entering 2022 with very robust demand. The last series of lockdowns is unlikely to be prolonged. This will support consumer sentiment and the continued release of pent-up demand. However, we see a slowdown once these tailwinds fade probably after summer. Moreover, we recognise Europe's exposure to the Chinese economy, which has slowed and while we believe that stimulus is set come it will take time to feel the effects. Finally, we should be aware of a potential rise in geopolitical tensions, such as the migrant crisis on the EU-Belarus border and between US and China.

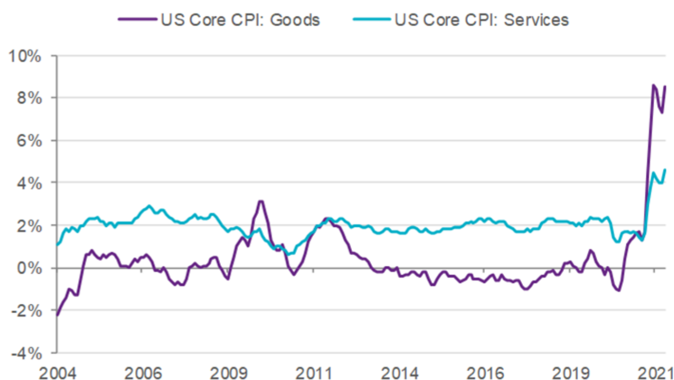
On the political front, the risk of Democrats losing control of the House, Senate or both in next November's US midterm elections has increased, which should translate into President Biden avoiding unpopular policy measures. In addition, the version of the Build Back Better plan that was recently passed in the House indicates that most of the corporate tax provisions in a final Senate-passed bill would take effect in 2023 and not 2022 as previously assumed.

Moreover, two major European countries, France, and Italy, will also host presidential elections in 2022 French President Emmanuel Macron will be looking to secure a second term in April. Meanwhile uncertainty is building around whether current Italian Prime Minister Mario Draghi will become President, which would allow him to oversee many elements of the Italy's Next Generation EU agenda for the next seven years. Whatever the outcome, we do not see these developments materially altering political stability in Europe.

Inflation should stabilize closer to target levels

Although we believe that we might still see higher inflation prints emerging from the US and Europe in the short term, price pressures should broadly subside over the course of next year as supply-demand mismatches get resolved and labour market tightness eases. We expect, however, that inflation will remain at a healthy pace in line with central banks' targets for some time before the still present demographic and technological deflationary pressures kick in again.

Supply constraints are likely to remain in place for some time, which should not surprise anyone given that personal consumption expenditure on goods is 25% above pre-pandemic levels in the US. But, as the reopening unfolds in 2022, we expect to see a shift from spending on goods to spending on services, which should help ease supply chains. This, however, poses the question of whether this goods-driven inflation will be replaced by increasing services prices once consumers turn to consume more "events" and less items.



Source: Bloomberg, NIM Solutions.

Furthermore, there is the case to be made that the labour tightness we are currently witnessing will not ease as quickly as expected. In the US, for instance, there is a 3 million worker shortage (the difference between current job openings and people unemployed) composed mainly of people who have abandoned the workforce. Over a third of that group is above the age of 55, which means that they could be encountering difficulties in getting back their jobs; or, conversely, they may not be willing to return to work given their savings and wealth accumulation experienced during the pandemic. And, as it has been the case in the UK, a part of that group of people may well have left the country and there is no certainty about their return. And, as it has been the case in the UK, a part of that group of people may well have left the country and there is no certainty about their return.

Moreover, we do see commodity prices, particularly those related to energy, staying elevated since countries that account for over 70% of global GDP have pledged to reach net zero CO2 emissions by 2050. Likewise, this transition will probably continue to constrain fossil fuels supply due to the lack of investment in CAPEX, which is at historic lows, driving prices higher. At the same time, the increasing energy demand coming from emerging economies is likely to outpace renewables output, which still needs its global investment to triple by 2030 to replace fossil fuels in the energy mix.

Central banks remain data dependent

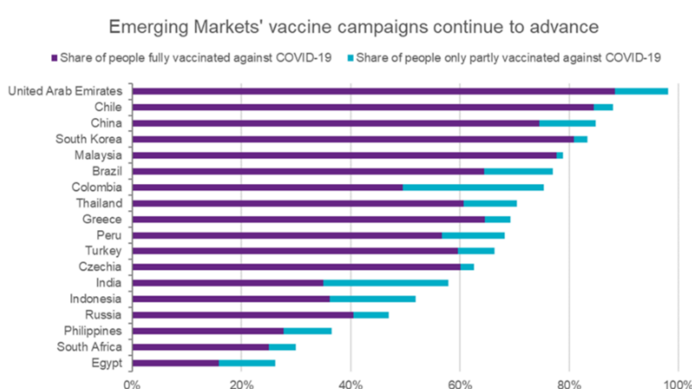
Some central banks – such as those in Norway, Canada, and Australia – have already taken steps toward tightening monetary conditions. However, the Federal Reserve (FED) and the European Central Bank (ECB), which arguably are of more relevance for global risk assets, have so far taken a more patient approach. Both central banks have released new monetary frameworks that indicate that they are now willing to generate higher inflation to support job creation. Furthermore, we have long suggested that these central banks would want to avoid an early rate tightening, which would have had close to no effect (if not negative) in improving supply constraints and could risk derailing the economic recovery.

However, we believe that if inflation were to remain high beyond the supply disruptions or if it turns to be less slack in labour markets, central banks could turn more hawkish. In fact, we could argue that we have already started to see this hawkish pivot since Powell's renomination as the FED chair. Since then, he has retired the word *transitory* from the current rise in prices and he has hinted at an acceleration of the bank's tapering timeline. But, overall, we think that the moderating inflation backdrop we expect for the first half of 2022 should give the FED some leeway to gradually reduce its accommodative policy and start hiking rates only by next summer. The ECB, for its part, is expected to end its pandemic stimulus support in early

2022, but it is likely to remain more patient when it comes to raising rates, since wage growth has been slower to pick up than in the US and the European economy is more dependent on the situation in China.

Emerging markets

The emerging world is at an earlier stage its vaccine roll-out and, thus, policymakers are still imposing mobility restrictions. China, for instance, will likely keep its Zero Covid stance until at least after the Winter Olympics in February. However, a large proportion of the population in emerging markets is set to be inoculated in the coming months, which should add support in the second half of the year.



Source: Our World in Data, NIM Solutions.

However, many of the economies have already closed the output gap generated by the pandemic, which makes us expect a tighter policy that could slow growth. Governments will have to decrease fiscal support to repair the large budget deficits incurred during the pandemic. In addition, some central banks have had to raise policy rates in response to inflationary pressures, which typically weighs in activity with some lag. And, following Chinese policymakers' move to restructure the economy away from the property sector in favour of more sustainable long-term growth drivers, countries dependent on some commodity exports could suffer.

Greenback on the front foot

Although the US dollar might continue to be supported by the market repricing for a quicker pace of monetary policy accommodation compared to Europe, we believe that we have already seen the bulk of the move. However, the relative stronger growth expected in the US versus the rest of the world should maintain the US dollar underpinned with any meaningful rise in Treasury yields helping to keep it biased higher.

Investment implications

Against this background, we prefer to moderately overweight equities in developed markets while remaining neutral on emerging markets, which also tend to suffer from a strong US dollar.

Within developed markets we favour equally both the US and Europe. In the short-term, the US economy seems more resilient and less prone to reimpose Covid restrictions that could hamper the economy. In addition, we see US relative outperformance against the rest of the world to continue until the market starts anticipating the end of the FED's tightening cycle. Europe is more cyclical and, hence, more exposed to the current Covid wave. However, once the visibility of the economic cycle improves again, European equities (and the Euro) should regain traction supported by attractive relative valuations.

Even if sector, style, and bonds' relative performance continue to correlate with the virus dynamics for some time, the cyclical sectors of the equity market should continue to benefit, while the normalization later in the year should favour defensive sectors such as healthcare. With a longer time horizon, and despite high valuations, we see opportunities in renewable energy sources and energy efficiency.

Moreover, we maintain our short duration exposure, particularly on the sovereign bonds bucket as we see inflation stabilizing above its long-term average. Besides, unless we were to face a significant challenge from a new variant, the short end of the yield curve should rise more than the long end. In addition, valuations from both sovereign and credit issuers are very high, while those of equity have actually come down after solid strong growth in corporate earnings. We continue to prefer credit over duration risk, although we acknowledge that current spreads leave less room for compression, particularly in investment grade. Despite very low default rates, high yield is not attractive as current rates do not compensate for the risk taken. Finally, we believe that EM debt in local currency in a selective manner and, to a lesser extent, in hard currency corporates as they should still offer a modest pick-up to similarly rated developed debt.

Conclusion

As we look to 2022, the outlook is one of continued growth and a slowing Covid dependence. As such, we keep a constructive view on risk assets that should continue to be supported by strong earnings and by the disbursements coming from the multi-year fiscal packages approved in the US and Europe.

Asset Classes	Negative	Neutral	Positive
Equities			●
Fixed Income	●		
Equities			
US			●
Europe			●
Japan		●	
Asia ex Japan		●	
Emerging Markets		●	
Asia		●	
Latam		●	
Europe		●	
Fixed Income			
Sovereign US	●		
Sovereign EUR	●		
IG US		●	
IG EUR	●		
HY US		●	
HY EUR		●	
EM Hard Ccy		●	
EM Local Ccy	●		
Commodities			
Oil		●	
Gold		●	
Base Metals		●	

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RCS Paris 453 952 681 - Capital : € 237 087 487 €
43, Avenue Pierre Mendès-France, 75013 Paris
www.im.natixis.com

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