

Market Compass

Outlook 2022



MARKET OUTLOOK

- Despite risks from Omicron, we retain a positive view on the economic recovery. Vaccines and new drugs will help the economy normalise in 2022.
- Yet the (cautious) policy support removal and stretched valuation will dramatically cut future (beta) returns. The diversification benefit is also set to fall as policy normalises and volatility will be higher.
- Risks are skewed towards more hawkish policy. We expect long-dated bond yields to rise, yet debt sustainability and financial stability risks will cap them. Credit will beat risk-free bonds again. We predict positive, yet lower and more volatile equity returns.
- The three main risks lie in a policy mistake causing financial havoc, a disorderly energy transition seeing a surge in selected commodity prices and a nasty variant escaping vaccine protection.

Edited by
**MACRO & MARKET
 RESEARCH TEAM**



A team of 13 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues.

The team translates macro and quant views into investment ideas that feed into the investment process.

US

- + Consumption and Capex will maintain growth at 4%
- But inflation will end the year at 3%, with substantial upside risks
- + Unemployment is falling faster than expected. Participation rate should catch up when infection risks subside
- ! The Fed is expected to raise rate three times. Net bond purchases end in March, but the balance sheet will not shrink before 2023

UK

- The fast-spreading of the Omicron variable puts our 4.7% growth forecast at risk
- Strong inflation and a very tight labour market forced the BoE to hike rate earlier than expected. Tight policy will continue
- ! Criticism on the handling of the pandemics puts PM Johnson at risk

EUROZONE

- + Expansionary fiscal policy and the NGEU funds will continue to support growth
- Despite the risk of Covid induced slow start of the year, GDP will increase by more than 4% in 2022
- Base effects, energy and supply bottlenecks should abate allowing inflation to get back to below 2% by year-end
- + ECB will terminate PEPP bond purchases in March but smooth the impact over the rest of the year via the standard APP program

CHINA

- + Monetary and fiscal support will continue
- + Cooling investment will cap GDP growth at 4.8% in 2022
- Monetary and fiscal support will continue

EMERGING MARKETS

- Growth prospects improve as the global economy continues to expand
- Inflationary pressures and risk of currency depreciation will force central banks to tighten further, especially in LatAm
- ! Political risks come to the fore again with the election in Brazil

- + Positive
- Negative
- ! Topics to watch

DIRECTION OF TRAVEL

- Prudent Equity overweight (OW).
- At the beginning of the year, sizeable OW in credit
- Maintain underweight (UW) in sovereign
- Trim short duration stance to a minimum to protect from risk of ECB early tightening
- Keep OW cash to protect from inflation

Equities

- Equities to benefit from a sustained nominal GDP growth causing an earnings growth of 10% in 2022.
- We see total returns of 7%, despite a mild PE compression (-4%) due to a more mature phase of the cycle and lower policy support, coupled with high inflation.
- All in, a cautious OW, with a slight OW in EMU vs. US.

Bonds

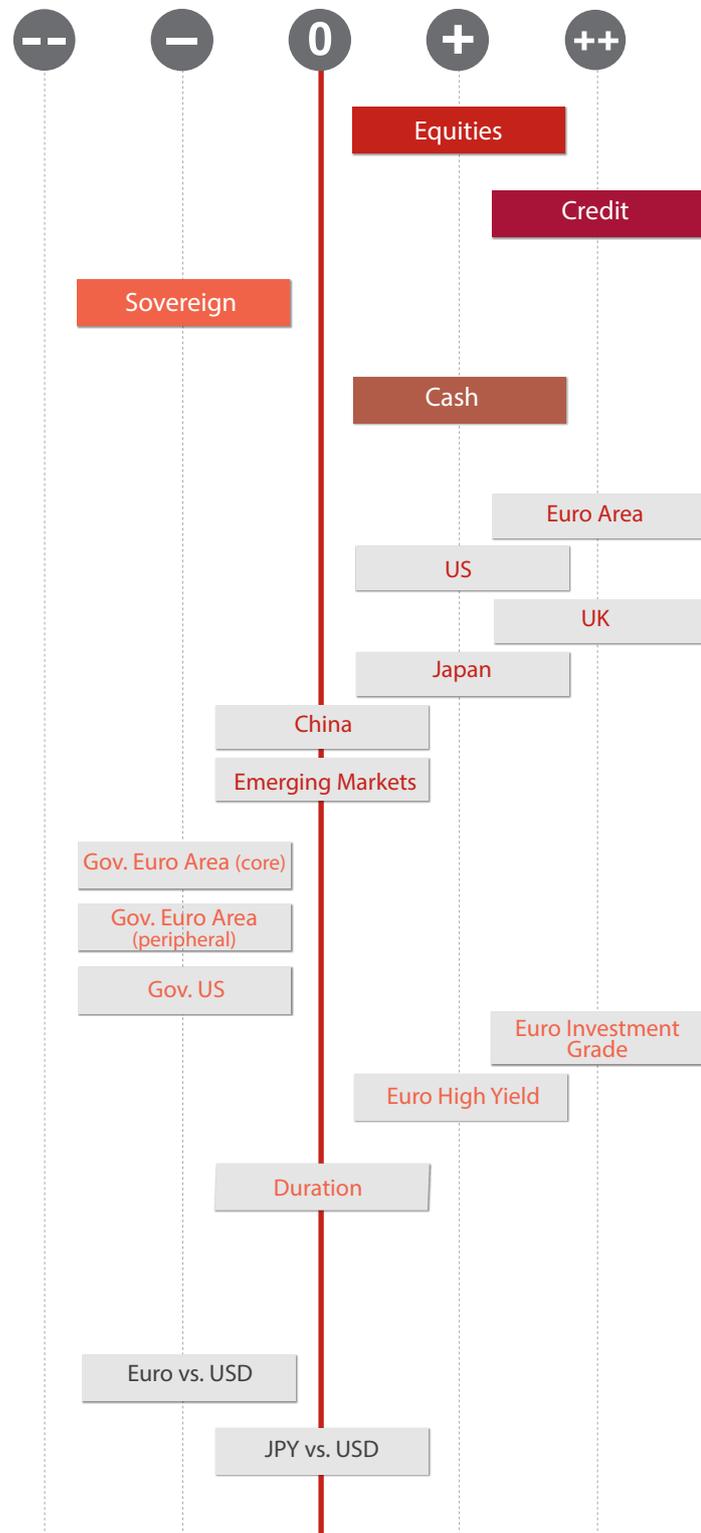
- Amid a tightening of monetary policies volatility of bond markets is seen to increase in 2022. Sustainably higher key rates will drive government bond yields upwards.
- Improving fundamentals will support credits, but we see some widening potential for government bond spreads.

Duration

- Moderately short duration recommended.

Currencies

- The USD still has legs into 2022 as the Fed will accelerate its policy normalization, which contrasts the more patient ECB and perma-dovish BoJ.
- Yet, USD valuation looks stretched and headwinds from the global recovery, the unfavourable US external balance and reserves diversification will mount over 2022.



TOPICS TO WATCH!

- Geopolitical tensions US/China (Taiwan)
- Longer supply disruptions and energy crunch hurt growth yet support rate hike fears
- Withdrawal of policy support hurting risk appetite and precipitating slowdown
- Mutations challenging vaccine effectiveness, new shutdowns

Probability:	Impact:

Probability: High \longleftrightarrow Low

Impact: High \longleftrightarrow Low

SPECIAL FOCUS

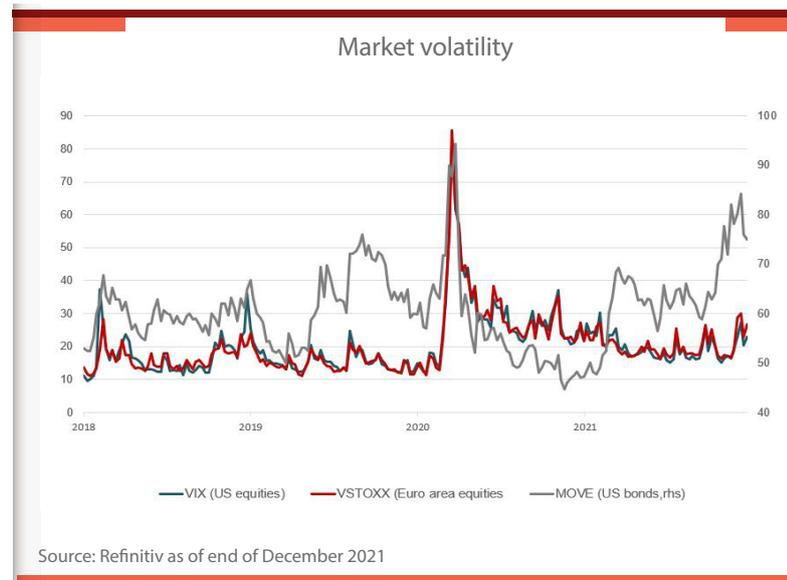
How to invest in 2022?

The most important financial variable to watch remains long-term real rates, which are an anchor to valuations across all asset classes. We expect self-correcting mechanisms (debt sustainability, financial and economic dependence on low long-term real yields) to keep the rise in bond yields limited in 2022, but the direction of travel is north.

Our view on credit is rather constructive. Solid fundamentals (cash positions, rating migration, low default rates, residual ECB support) and the recovery should keep spreads tight and ensure excess return against risk-free bonds. Expect the ECB greening implementation to significantly impact sector and security performance.

There is still life in equities, we see earnings growth of around 10% on both sides of the Atlantic, with a bias to the upside. The recovery should still support positive, if lower, returns. Valuation is not cheap, in absolute terms but it is when compared to bonds, and real yields. The PE gap between Europe and the US is wide; we have then a small preference for European stocks.

The upcoming Fed hikes keep the USD supported for now, yet the dollar is already starting to look rich on a fundamental basis. EM markets have generally underperformed relative to DM markets through the pandemic (FX, equity, and debt); we see more promising perspectives in 2022, but Fed hikes and near-term dollar strength will cap excess returns.



GLOSSARY

ECB'S ASSET PURCHASE PROGRAMME (APP)

The ECB's Asset Purchase Programme (APP) is part of a package of non-standard monetary policy measures that also includes targeted longer-term refinancing operations, and which was initiated in mid-2014 to support the monetary policy transmission mechanism and provide the amount of policy accommodation needed to ensure price stability.



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