

INSIGHT

QUARTERLY MARKET REVIEW

Q1 2022



Brighter outlook after
the fourth wave

OVERVIEW

Covid uncertainty gives way to better prospects

UK

Stagflation risk

LATIN AMERICA

Politics and the pandemic

SPECIAL FOCUS

Running out of workers?

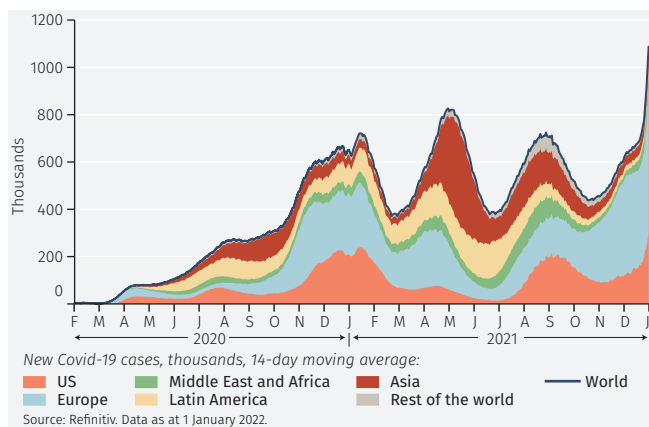
OVERVIEW

Although Covid concerns will feature in the first part of the year, we are generally optimistic about the outlook for global economic growth in 2022. With inflation rates set to fall back, the economic backdrop remains generally benign.

Global fourth wave

In early 2022 the predominant global concern is likely, once again, to be a surge in Covid cases – the fourth such wave (see Figure 1). Global economic growth was already hit towards the end of 2021 as the Omicron variant spread, some restrictions on movement were imposed and consumer sentiment was adversely affected. However, the impact varied widely from country to country. Europe was the hardest hit of the advanced economies. US economic growth, in contrast, seems to have remained relatively firm.¹

1. Fourth wave of Covid

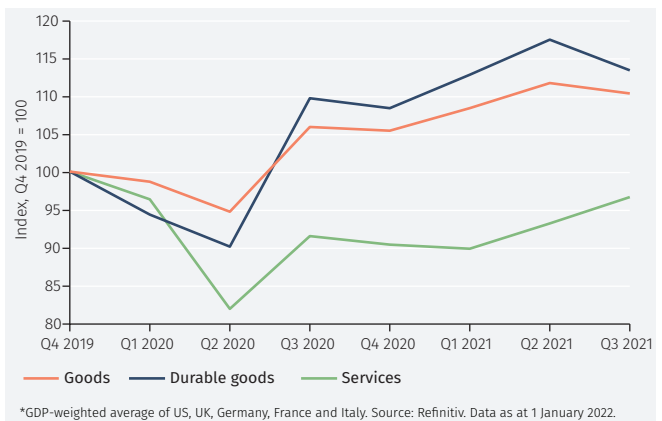


To some extent the world economy has grown accustomed to dealing with Covid. Global economic growth slowed very sharply in the first wave from March 2020 onwards but has been more resilient in subsequent outbreaks. The potential for a recovery later in 2022 remains and we see overall GDP growth at around 4.5% for the advanced economies and slightly faster than that in the emerging economies.

Savings and spending

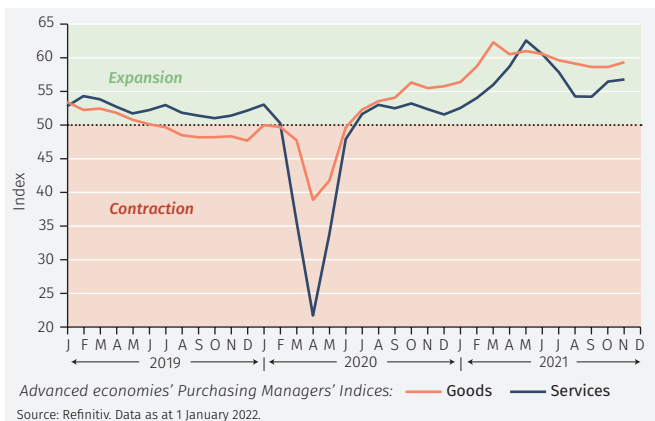
That assessment is based on three expected developments. First, we see a recovery in consumer spending on services such as entertainment, travel and live events. Across the main advanced economies, the latest data (to the third quarter of 2021) show such spending still below its pre-pandemic level (see Figure 2). Consumers have the ability to spend, given the household savings that have been accumulated during the pandemic and the increase in wealth due to asset price increases. In the US, for example, the net worth of households was USD 144.7 trillion at the end of the third quarter of 2021, almost 25% higher than immediately before the pandemic. The extent to which this translates into higher spending depends, of course, on consumer confidence and the willingness to spend. Survey data from purchasing managers showed some improvement in the services sector before the spread of

2. Consumer spending in advanced economies*



Omicron (see Figure 3) suggesting that such spending was already starting to recover. It remains to be seen how resilient this proves to be, but we are optimistic. Consumers and many businesses have, to a considerable extent, learned to live with Covid; we expect an increase in vaccination rates in countries that have lagged behind; the roll-out of new therapies, in particular a Covid pill, are likely in 2022.

3. Advanced economies' PMIs: goods and services



Second, we expect an easing of supply chain pressures, allowing pent-up demand for some goods to be satisfied and inventories to be rebuilt. The car and consumer electronics industries are two areas where such pressures have been most intense.

Third, the need for green infrastructure spending is substantial. To meet the objective of net zero carbon emissions by 2050, such spending is estimated at USD 4 trillion per year for the next quarter century, USD 100 trillion in total. The fact that government bond yields, in both

¹ The Federal Reserve Bank of Atlanta's 4 January 2022 GDPNow forecast is for 7.4% annualised growth in Q4 2021. <https://www.frbatlanta.org/cqer/research/gdpnow>

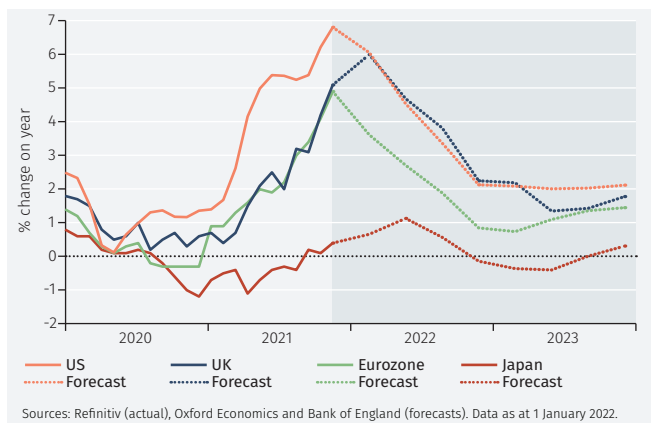
OVERVIEW

nominal and real terms, remain so low suggests that there is still a global savings glut which can be deployed to meet these infrastructure spending needs.

Low government bond yields and secular stagnation

Bond yields also indicate to us that inflation rates are not expected to remain high. Peak inflation rates are set to be reported in the first quarter, with rates then falling back towards 2% (see Figure 4).

4. Advanced economies' inflation rates



Very long-term government bond yields, such as the US Treasury 30-year yield, which cannot be explained by inflation trends over just a year or two, have trended lower over a number of years (see Figure 5). This can be taken not just as an indication of a global savings glut but also of secular deflationary forces. If that is the correct interpretation then after the recovery in 2021 and 2022, global growth can be expected to revert to its pre-pandemic relatively slow rate (2% or less for the main advanced economies).

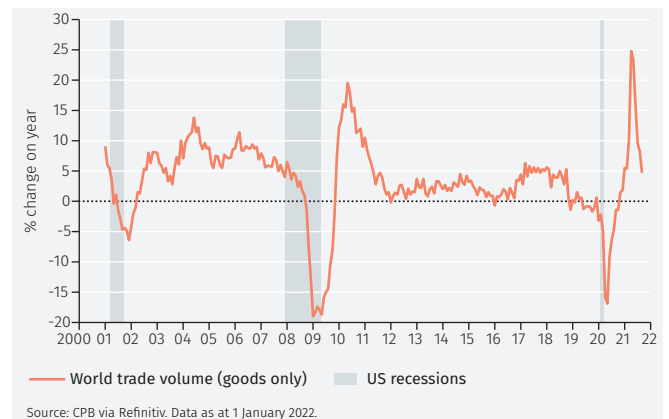
5. US 30-year Treasury yield



Globalisation and the emerging economies

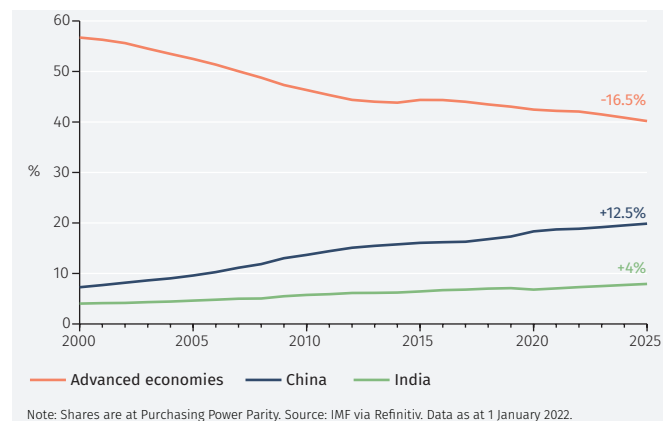
Two other big longer-term questions about the global economy are also pertinent. First, whether globalisation is under threat, especially as a result of the trend to reshore production. Our view is that there are limits to the extent this can take place, particularly because of a lack of skilled labour in those countries seeking to reshore (see *Special Focus*, page 11) and the complex nature of global supply chains. Global trade in goods is likely, we think, to continue to grow at a rate similar to that seen in the period 2012-2019 (see Figure 6), with potential for faster growth in services.

6. World trade growth



Second, whether the importance of the emerging economies in driving global growth will continue. In practice, only two emerging economies – India and China – have accounted for all the decline in the advanced economies' share of global GDP since 2000 (see Figure 7). We are optimistic that other emerging economies, propelled by the adoption of digital technologies, can now catch up.

7. Shares of world GDP



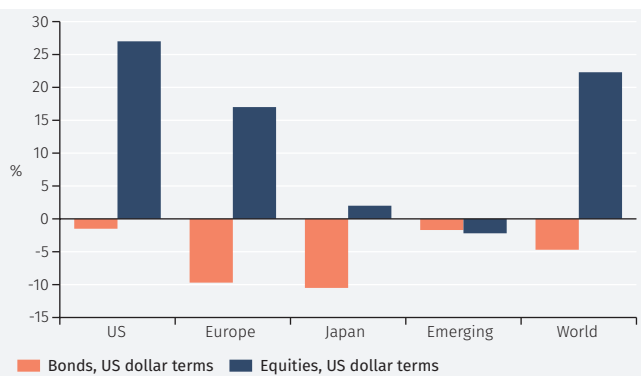
ASSET MARKET PERFORMANCE

2021 saw strong returns from global equity markets, led by the US. The US dollar strengthened against most currencies. Bond markets were under pressure from a rise in yields, reflecting concerns about inflation.

Asset market performance

World equity markets saw gains of 22.3% in 2021 (see Figure 8) on the basis of the total return from the MSCI World Index in US dollar terms. Global bond market returns, in contrast, were negative, at -4.7% on the basis of the Bloomberg Barclays Global Aggregate Index.² In almost all markets local currency returns were undermined, in US dollar terms, by currency depreciation.

8. Asset market performance

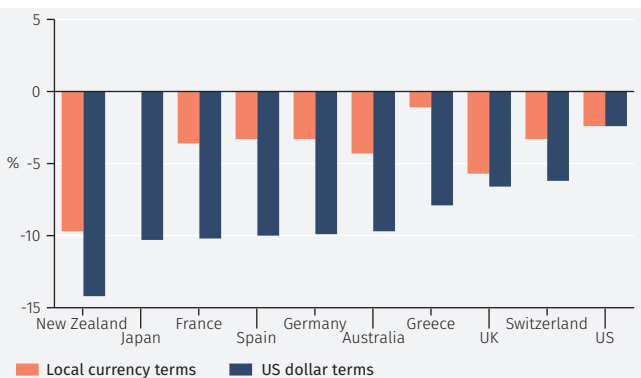


Sources: Barclays Bloomberg (bonds); MSCI (equities). Data for twelve months to 31 December 2021. Past performance is not necessarily a guide to the future.

Bond markets

There was a general rise in longer-dated bond yields – and a consequent decline in prices – in 2021. 10-year yields rose by 59 basis points to 1.50% in the US; and by 40 basis points to a still negative rate of -0.18% in Germany (see Figure 9). New Zealand saw by far the largest increase with yields rising 131 basis points to 2.4%. These increases were predominantly

9. Bond market returns



Source: Refinitiv. 10-year benchmark bond total returns. Data for twelve months to 31 December 2021. Past performance is not necessarily a guide to the future.

driven by concerns about the persistence of higher inflation and future hikes in central bank policy interest rates.

In the UK, 10-year yields rose by more than in the US and sterling also showed modest weakness against the US dollar. The weakness of the Japanese yen meant that zero returns in local currency terms translated into sharply negative returns in US dollar terms.

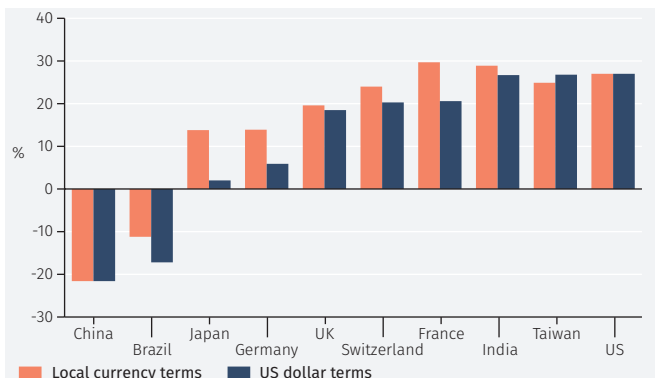
Across all eurozone bond markets and, to an even greater extent in Switzerland, returns in US dollar terms were undermined by local currency weakness.

Equity markets

In the major developed markets, US equities produced the strongest returns, amounting to 27% in 2021 (see Figure 10). Tech companies were an important driver of US returns, as they were in Taiwan's strong performance. In Europe, one notable divergence was the stronger performance of France and Switzerland compared to Germany, largely due to the different composition of their equity indices (the French and Swiss indices have a high composition of luxury goods and pharmaceutical companies, respectively).

Although returns from Japanese equities were 13.8% in yen terms, the currency's weakness meant these were reduced to just 2.0% in US dollar terms. In the major emerging markets, India produced the strongest performance but returns in China were weak. Concerns about the regulatory framework and the prospects for the property sector weighed on the Chinese market, especially from mid-year onwards.

10. Equity market returns



Source: MSCI. Data for twelve months to 31 December 2021. Past performance is not necessarily a guide to the future.

² The Bloomberg Barclays Global Aggregate Bond Index is a benchmark of government and investment grade corporate debt from developed and emerging markets issuers in 24 countries.

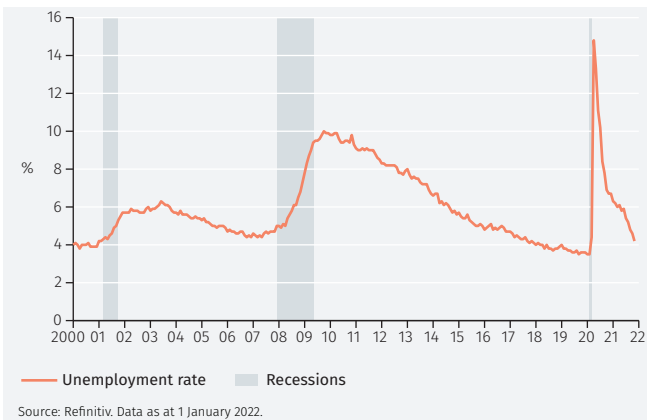
UNITED STATES

The US economy has made a strong post-Covid recovery, most clearly in the labour market. After some headwinds in the first quarter, continued expansion should be seen in the rest of 2022.

Labour market tightness

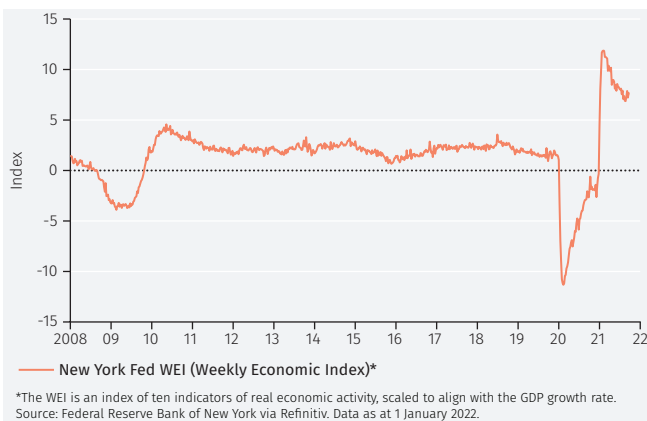
Perhaps the clearest signal of the post-Covid recovery in US activity is the sharp decline in the unemployment rate (see Figure 11). At just 4.2% in November 2021, the rate is only slightly above its pre-pandemic level. After the global financial crisis, it took ten years for the unemployment rate to fall back to its pre-crisis level. The much quicker adjustment can be seen as a testament to the flexibility of the US labour market. For example, as retail sales have moved online, employment in physical retail stores has declined as the number of jobs in warehousing and manufacturing have increased. However, it also reflects a decline in the participation rate – there are fewer workers – a subject we address in the *Special Focus*, page 11.

11. US unemployment rate



The rapid reaction of policy to the pandemic – the shift to near-zero interest rates, massive asset purchases by the Fed and direct fiscal support – has clearly, however, played an

12. US weekly economic index



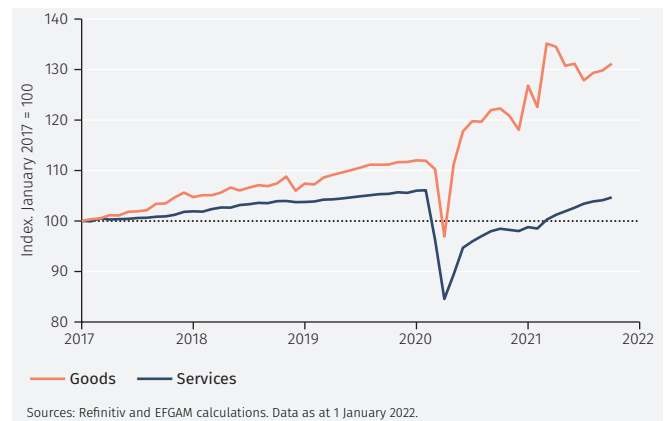
important role. That support will be scaled back in 2022 and poses a risk to US growth.

Growth holding up but challenges for 2022

There are three other risks to US growth, varying over their timescale. In the near future, the impact of the spread of the Omicron variant of Covid may hit both consumer spending and output. So far, high frequency economic data suggest only a modest slowing of the US real growth rate towards the end of 2021 (see Figure 12). Overall, the final quarter of the year is likely to have seen strong economic expansion. But the one thing which is certain about Covid is its unpredictability.

Looking further ahead into 2022, we see a recovery in consumer spending on services – such as travel, tourism, attendance at live events and personal care. Such spending is still below its pre-Covid level (see Figure 13) whereas spending on goods and especially durable goods is much higher; but there is a risk that this recovery in services spending may be delayed until later in 2022.

13. US consumer spending trend



The third concern is that after a recovery in activity in 2022, the US may revert to a lower growth rate. Between 2012 and 2019 the average annual growth rate was around 2.0%, a rate which is broadly to be expected given longer-term productivity and demographic trends.

The more unlikely, ‘tail risk’ is that inflation remains elevated for longer than expected and more aggressive tightening by the US Fed is required to bring it under control. Much more likely, in our view, is that inflation does subside later in 2022 and that the need for Fed tightening is modest – perhaps less than the three 25 basis point increases in the Fed Funds rate which the market was discounting at the start of 2022.

UNITED KINGDOM

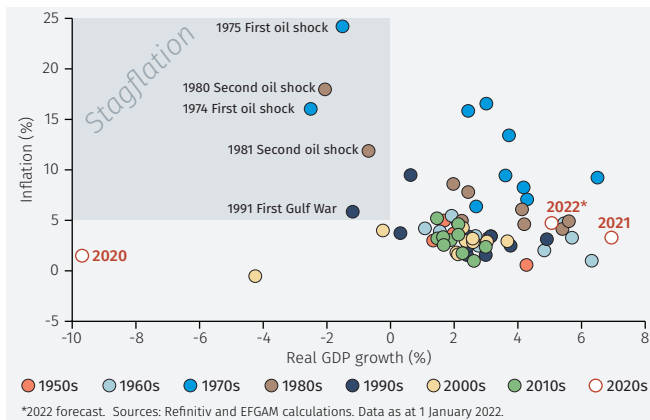
Stagflation – no growth or a contraction in real GDP and high inflation – has been seen in the UK in the past. It is a current, although likely temporary, risk.

Stagflation in the past

“Stagflation is not a word we use” according to Andrew Bailey, governor of the Bank of England.³ The term is, however, in widespread use outside that institution. It refers to the combination of stagnation in the economy – no growth or a contraction in real GDP – and high inflation.

The UK has seen stagflation (see Figure 14) in three periods: 1974 and 1975; 1980 and 1981; and 1991. The first two were related to oil market shocks, when prices rose by around 300% and 200%, respectively; the third period, at the time of the first Gulf War, saw a smaller oil price rise (34%).

14. Stagflation in the UK



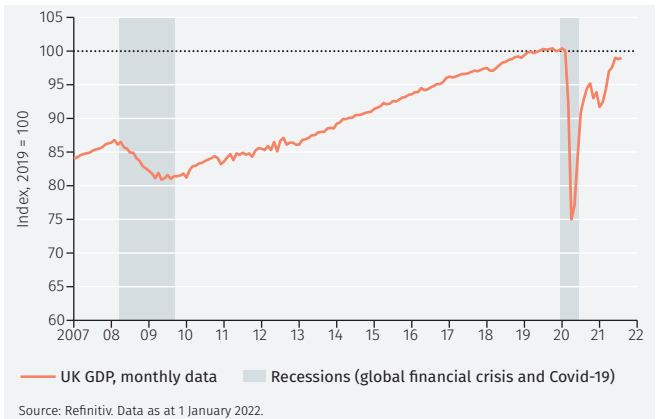
Given the 270% rise in oil prices between the low in 2020 and the peak in 2021 there is, on that basis, a risk of stagflation once more. Correlation is not causation, of course. Monetarists would point out that those periods of high inflation in the past were preceded by rapid monetary growth. But the antecedents also included loose fiscal policy and a weak sterling exchange rate.

The current threat

The current threat of stagflation is evident from short-term forecasts. The hit to GDP growth from the Omicron Covid variant is highly likely to see GDP fall between November and December 2021 and, most likely, also fall between the final quarter of 2021 and the first quarter of 2022. That would mean the UK would still remain below its pre-pandemic level of GDP (see Figure 15) in the early part of the year.

Inflation, the Bank of England now forecasts, will peak at 6% in the first quarter. There are clear cost push pressures, not

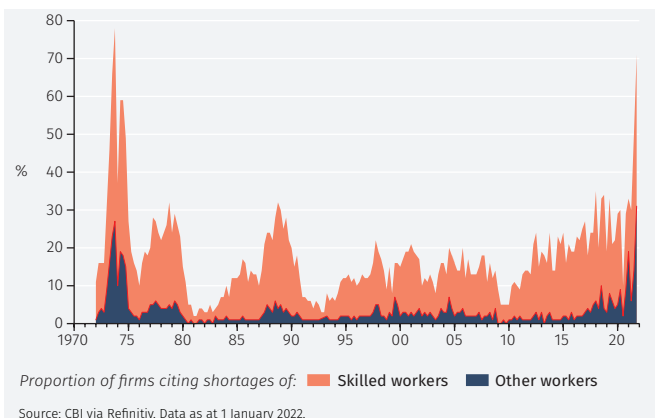
15. UK monthly GDP



just from higher oil prices but also from labour market shortages (see Figure 16) and supply chain disruptions. As in the past, the antecedents include rapid monetary growth, a surge in the government’s fiscal deficit and and sterling weakness. So, sometime early in 2022 the alignment of growth and inflation readings is likely to qualify the UK as being in stagflation.

For 2022 as a whole, however, rapid GDP growth and some fall back in inflation (consensus forecasts are for a 5% year-on-year average change in both measures) are likely to mean that the word the Bank of England does not use will not need to be deployed.

16. Labour shortages limiting production



³ Monetary Policy Report press conference, 4 November 2021. <https://tinyurl.com/2bket9ps>. Ben Broadbent, Deputy Governor for Monetary Policy, preferred the description “a classic trade-off inducing shock” to explain the rise in inflation and fall in GDP from higher oil prices.

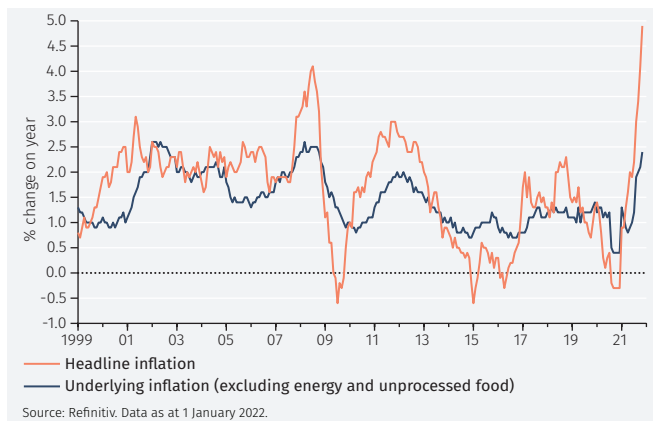
EUROZONE

The challenges always evident in managing monetary policy for the eurozone's diverse group of member states are compounded by high and divergent inflation rates and a large output gap.

17. Eurozone headline and underlying inflation

The headline eurozone consumer price inflation rate rose to 4.9% in November 2021, the highest since the euro's formation in 1999. Excluding energy and (unprocessed) food prices, however, the rate was less than half that, at 2.4% (see Figure 17). Such measures are used by central banks based on the view that excluding volatile components, such as food and energy, provides a better assessment of underlying trends.

17. Eurozone headline and underlying inflation



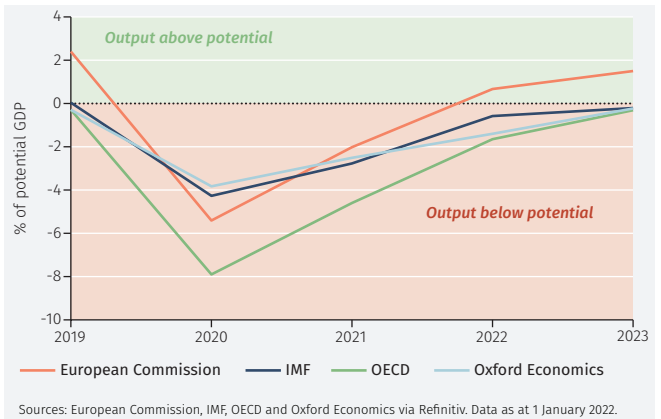
If the 2.4% rate is indeed more representative of underlying inflation, it is broadly in line with the European Central Bank's symmetrical 2% target (introduced in July 2021). Although that change of target, from the previous formulation of 'less than but close to 2%' can be seen as trivial, we think it is important. In particular, it means that inflation temporarily above 2% is acceptable.⁴

Two concerns

Even so, there are two concerns about inflation prospects.

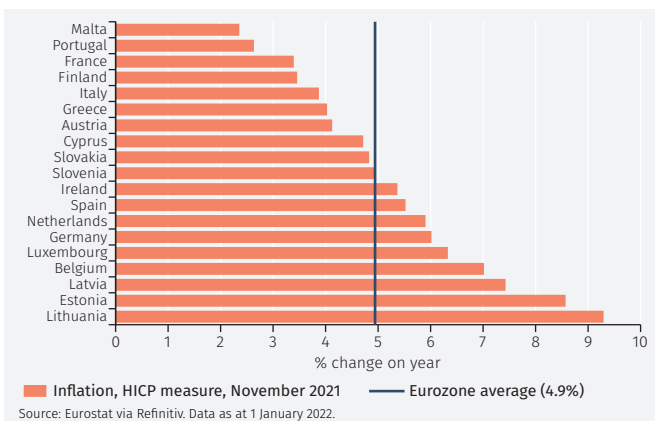
First, eurozone GDP is still below potential. Estimates vary, with the four measures shown in Figure 18 putting output at between 2% and 4.5% below potential in 2021. All but one of the four estimates shows that gap persisting in both 2022 and 2023. An output gap of that magnitude would normally be expected to produce downward pressure on inflation. So, the current underlying rate of over 2% is more of a concern than it might at first appear. Additionally, the output gap estimates vary widely across the 19 member states of the eurozone, with some already above potential (the Baltic states and Slovenia) and several large member states (Italy and France, in particular) expected to be above potential in 2023.

18. Eurozone output gap estimates



Second, partly reflecting that divergence of output gaps, the divergence in inflation rates is the widest it has ever been since the euro's formation (see Figure 19). In the Baltic states the latest inflation rates are between 7% and 9%; the rate is barely above 2% in Malta and Portugal.

19. Eurozone inflation dispersion



Perhaps because it is mindful of the policy mistakes it has made in the past – notably, raising interest rates in July 2008 as oil prices reached a temporary peak and shortly before the onset of the global financial crisis – it is highly likely that the ECB will retain its accommodative monetary policy throughout 2022.

Specifically, asset purchases are likely to continue throughout 2022, absorbing almost all net new government bond issuance.

⁴ The ECB's New Framework: The Bright Spots Are in the Grey Areas, Stefan Gerlach, <https://tinyurl.com/2zuj338a>

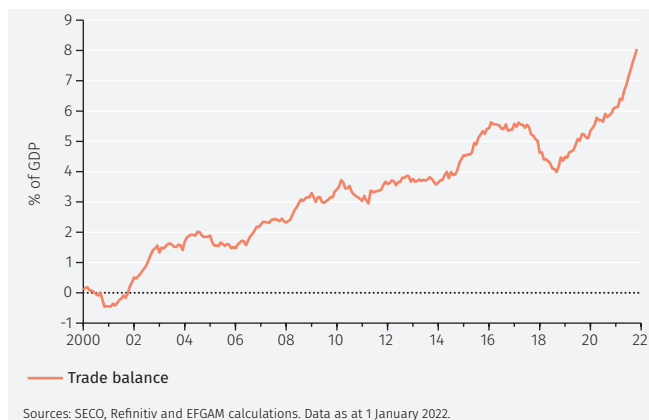
SWITZERLAND

The Swiss economic recovery continues. GDP is expected to grow by more than 3.5% in 2021 and about 3% in 2022. The favourable outlook is underpinned by strengthening international trade and an accommodative monetary policy.

Trade surplus widens

Switzerland, a small open economy, is very sensitive to international trade. In addition, its specialisation in the production of pharmaceutical and chemical goods makes its exports very competitive. Unsurprisingly, the Swiss trade surplus rose to a record CHF58.2 billion, equivalent to 8.1% of GDP, in the twelve months to November 2021 (see Figure 20). The rapid rise of exports supports the manufacturing sector, which so far has coped with the global supply chain bottlenecks better than most Swiss trading partners.

20. Switzerland: trade balance



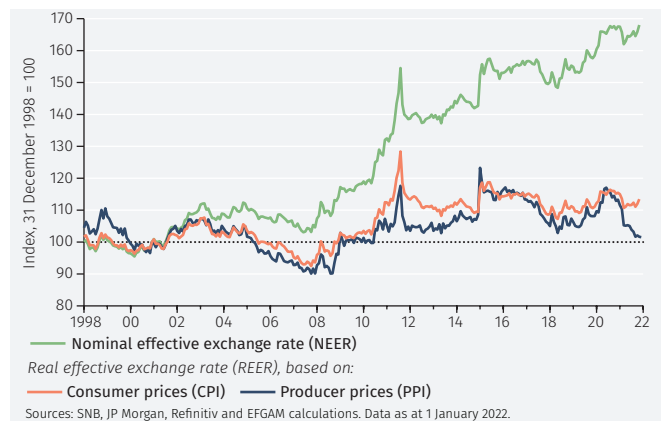
Expansionary SNB policy

Despite the favourable growth outlook, the Swiss National Bank (SNB) has reconfirmed its expansionary monetary policy stance, based on negative interest rates and the readiness to intervene in foreign exchange markets to counter any excessive appreciation of the Swiss franc.

The SNB has revised up its inflation forecast for 2022 but left 2023 and 2024 forecasts unchanged at 1% year-on-year. Inflation over the policy-relevant horizon is therefore expected to remain at the low end of the 0-2% range which the SNB uses to define price stability. This reflects the expectation that energy prices and supply chain bottlenecks will moderate over time. Hence, the SNB has signalled that it does not feel much pressure to change monetary policy for some time to come.

Moreover, President Jordan has explained that the impact of the franc's rise has been mitigated by high inflation in other countries, so that the real exchange rate, adjusted for consumer price inflation, has remained almost unchanged since the start of the pandemic (see Figure 21).

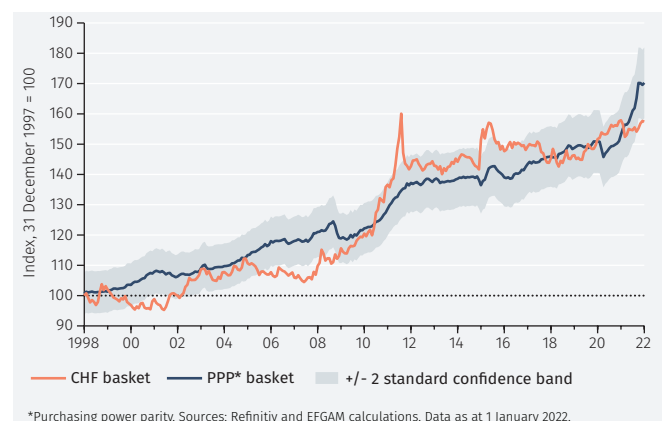
21. Swiss franc exchange rate indices



Swiss franc exchange rate

However, the picture is different when looking at producer price differentials.⁵ On this measure, the franc has depreciated by 7.5% since the start of the pandemic, returning to levels seen in the late 1990s. Furthermore, the recent widening of the producer price inflation differential between Switzerland (3.3% in November) and the eurozone (21.9% in October) and the US (13.6% in November) implies that the estimated equilibrium Swiss franc exchange rate⁶ has risen substantially against a basket composed of the US dollar and the euro (see Figure 22). This suggests that the Swiss franc may strengthen further and that reaching parity on the EUR/CHF exchange rate is only a matter of time.

22. Swiss franc exchange rate basket and PPP*



⁵ PPI is considered because it is a timely proxy for export prices and it is available at monthly frequency for most economies.

⁶ Based on Purchasing Power Parity (PPP).

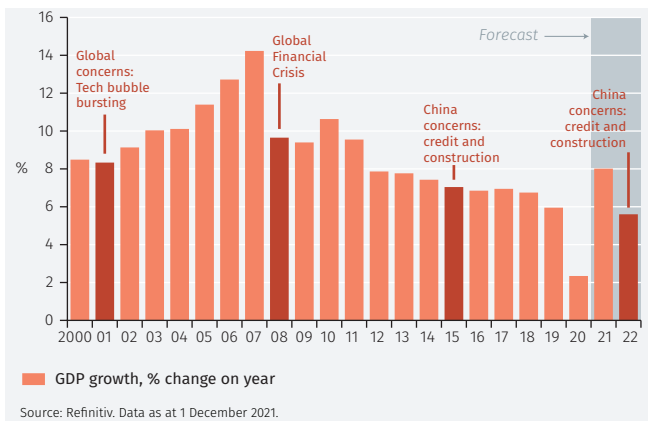
ASIA

For the last two decades there have been recurrent concerns about China's economic growth prospects. Covid, credit and construction trends are the current near-term concerns. Longer-term issues relate to demographic trends and governance.

China: recurrent concerns

There have been recurrent concerns about China's growth prospects over the last two decades (see Figure 23). Some threats have been external (such as the global financial crisis) while others have been more domestic in nature. Each time, the concerns were exaggerated. China, particularly with a skilled manipulation of policy settings, was able to avoid a sharp slowdown.

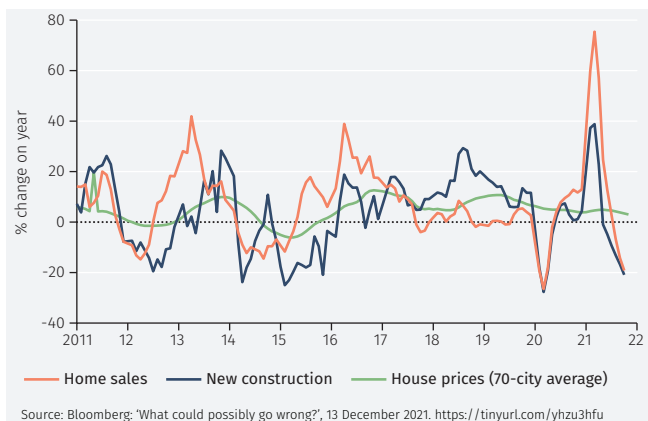
23. China's growth: recurrent concerns



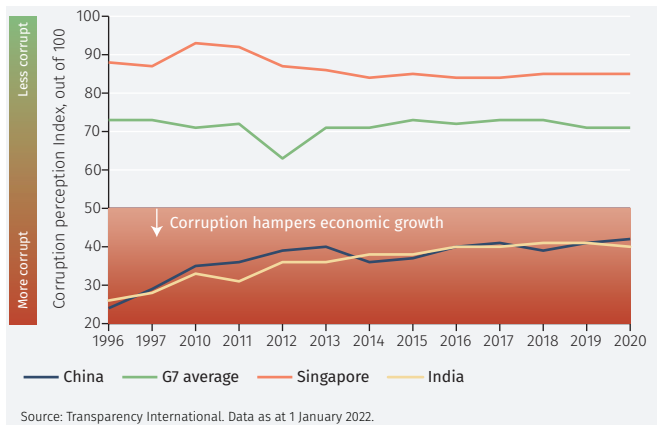
This time, there are near-term and deeper, longer-term issues. China's 'zero Covid' strategy involves mass vaccination, immediate and strict action to contain any outbreaks and tough restrictions on travel into and out of the country. If repeated lockdowns and travel restrictions are required, maybe because vaccines are not as effective against new Covid variants, then trade and growth will be hit.

That comes on top of the concerns about the housing sector, where sales and new construction are now contracting sharply (see Figure 24).

24. China: home sales, construction and prices



25. Corruption perceptions in Asia



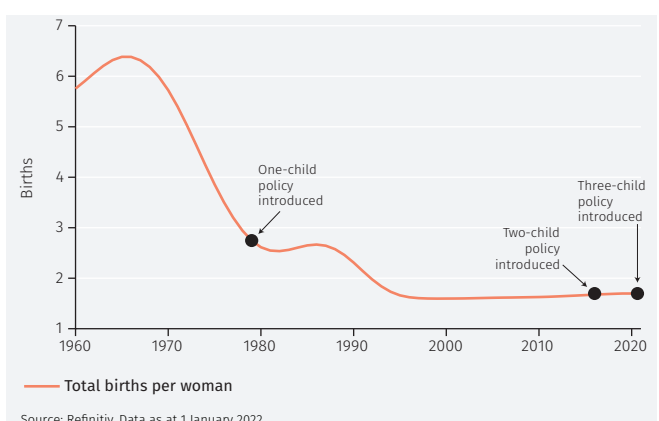
Given that housing accounts for between a quarter and a half of China's growth, and much of this has been financed by debt, the risks are evident. A multi-year workout, rather than a 'Lehman moment', still seems the most likely solution. The main reason is that China's predominantly state-controlled banks are likely to facilitate a restructuring of property-related debt with some form of government assistance.

Governance and demographics

Two bigger longer-term questions relate to China's governance and demographics. China is still perceived as an economy where corruption is high, at a level which impedes economic growth (see Figure 25). India is in a similar position. Chinese demographics are also a restraint to growth. Fertility rates have dropped sharply (see Figure 26) despite the move to allow more children. The working age population has almost certainly peaked (see *Special Focus*, page 11).

Overcoming China's current challenges will be more difficult than in the past.

26. China: fertility rate



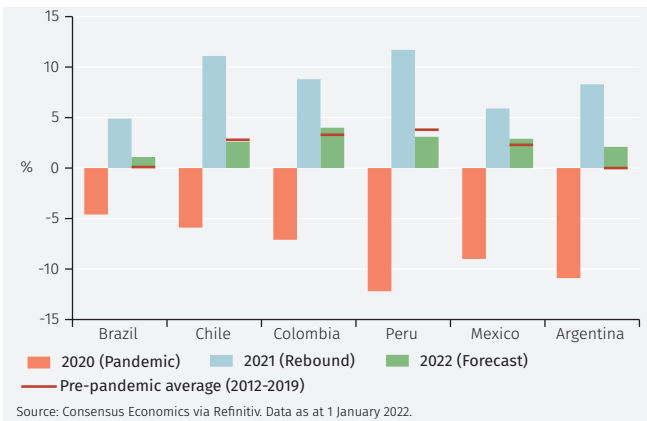
LATIN AMERICA

After the sharp rebound in 2021, Latin American growth is set to return to a more normal pace in 2022. Risks to growth, especially in Brazil, seem to have been exaggerated.

A return to 'normal'

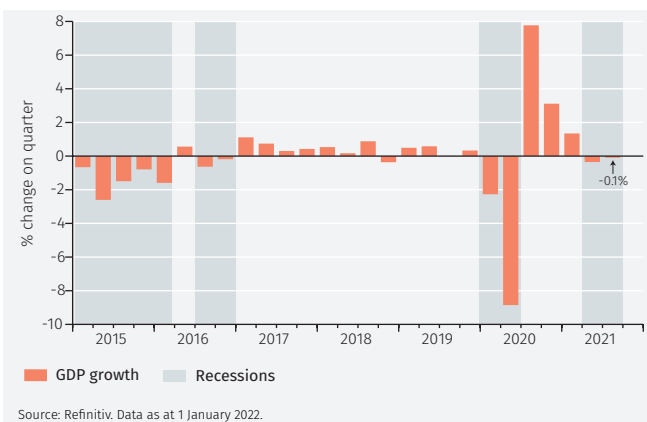
Latin America was one of the regions worst affected by Covid in 2020 but made a strong rebound in 2021. That rapid growth looks set to give way, in 2022, to a rate of growth similar to that seen before the pandemic (see Figure 27).

27. LatAm GDP growth: return to pre-pandemic rates



In Brazil, there has been a good deal of pessimism about growth prospects. The economy has already entered its fourth recession since 2015 (see Figure 28) and forecasts for 2022 have been cut sharply. The concerns relate to tighter policy – particularly higher interest rates – and political uncertainty ahead of the November presidential elections. That might deter inward investment and further progress with structural reforms.

28. Brazil: fourth recession since 2015

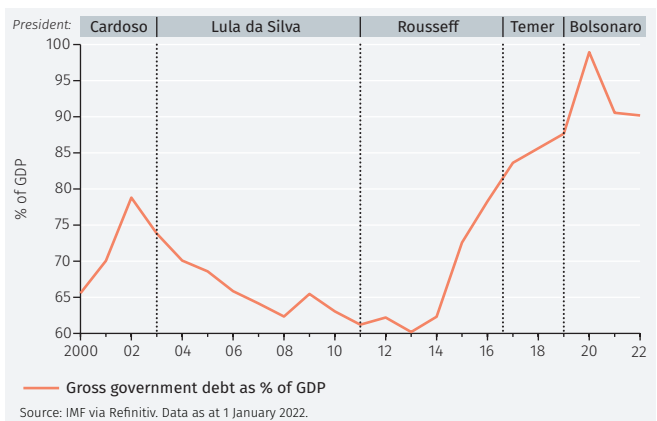


Brazil: a more optimistic take

The pessimism about Brazil's prospects is, we think, overdone. It is true that interest rates have risen sharply, but this is a welcome indication of the independence of the

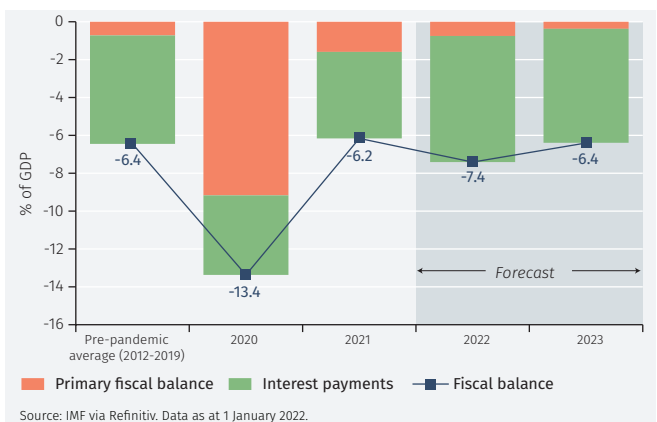
central bank which, we think, will manifest itself in a return to lower inflation, interest rates and bond yields. Meanwhile fiscal policy has been managed responsibly. Although the level of government debt relative to GDP rose sharply in 2020 (as nominal GDP contracted) the recovery in the economy saw that fall back: it is only marginally higher than pre-pandemic (see Figure 29).

29. Brazil: debt burden rising



Constitutionally, government spending cannot rise in real (inflation-adjusted) terms. That law was suspended in 2020 and there was a sharp increase in the government's primary deficit (see Figure 30). That was appropriate at the time. It is now returning towards balance, although higher interest payments will weigh on the overall fiscal deficit.

30. Brazil: fiscal balance



Brazil has also, after a very slow start, made good progress with controlling the pandemic, with much of that due to local production of vaccines.

SPECIAL FOCUS: RUNNING OUT OF WORKERS?

One of the unexpected consequences of Covid has been a decline in the participation ratio – those employed or seeking work as a share of the population. Adding to pre-existing demographic concerns, could the world run out of workers?

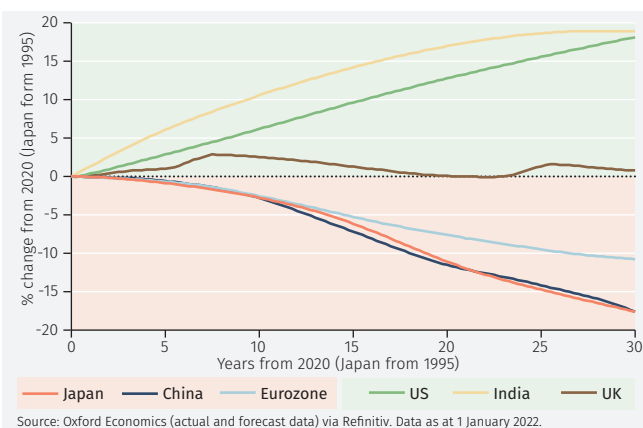
Malthusian trap

Concerns about a global population explosion were raised two centuries ago by Thomas Malthus. He argued that population growth would far exceed the ability of the world to produce food: the 'Malthusian trap'.⁷ By one means or another (war, famine, pestilence or birth controls) population growth would be restricted. China's one-child policy, introduced in 1979, echoed those concerns. But Malthus was wrong. The world's population, around one billion when he wrote, will likely pass 8 billion soon (it was 7.92 billion on 1 January 2022); and there are now more obese than underweight children in the world.⁸

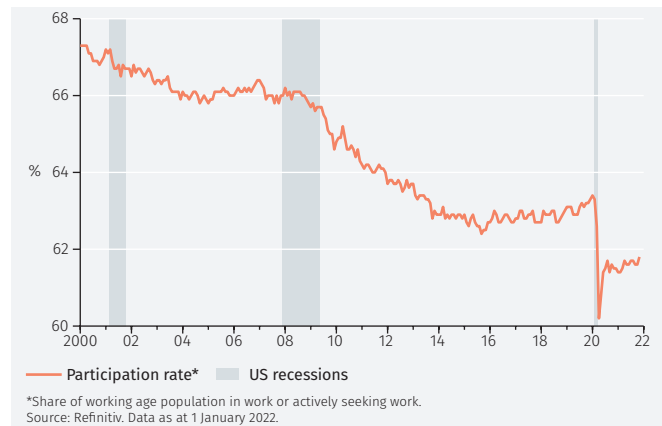
Decline in the population of working age

Elon Musk recently took a very different view to Malthus: there are not enough workers and this could threaten human civilisation, unless AI and robotics develop quickly enough.⁹ Although the working age population in the US is expected to increase over the next 30 years or so (see Figure 31) and a similar trend is expected in India, the decline in China is expected to follow the trend seen in Japan which started in 1995. The decline in the eurozone is not as marked (but this reflects a sharp decline in the peripheral countries and growth in the core countries). The UK working age population is forecast to be broadly flat.

31. Population of working age



32. US participation rate



The Great Resignation

Adding to concern about that decline in the population of working age, the participation rate has fallen in many economies (the US trend is shown in Figure 32). The phenomenon has come to be described as 'The Great Resignation'. Long-term Covid-related sickness, the difficulties of working from home during the lockdown especially with regard to childcare needs and concerns about exposure to the virus have been contributory factors.

But more important than these factors has been the support provided to households. Cash payments to households made during the pandemic, which in the US totalled USD 2 trillion, about USD 16,000 per household, have provided a disincentive to seek work, reducing the participation rate by 0.6 percentage points (around one half of the decline) according to one estimate.¹⁰ In Europe, where job retention programmes (such as the UK furlough scheme) were more widely used, the decline in the participation rate has been smaller. Even so, work by Morgan Stanley found that 36% of Europeans earn additional income through content creation platforms, e-commerce and trading (e.g. Bitcoin and NFTs), of which over 40% aspire to leave their jobs within two years.¹¹

The Great Resignation may prove to be a lasting, but unintended, consequence of Covid and the policy reaction to it.

⁷ *An Essay on the Principle of Population*, Thomas Malthus (1798)

⁸ *The Economist World Ahead 2022*, 'Growing up—and out'

⁹ <https://tinyurl.com/bdeyv32m>

¹⁰ <https://tinyurl.com/2p8dkmsw>

¹¹ *What If...The "Great Resignation" Doesn't End?*, Morgan Stanley, 24 November 2021.

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