Themes for 2022 as seen by the Eco&Strat team

Developed economies: *Growthflation* will be good for equities
2022 will see the recovery continues in the developed world as the economic cycle shifts into a more mature phase, particularly in the US which looks to be running a little ahead of Europe. The new phase will still be good for equities markets. With interest rates still low and inflation running high, investors will have good reason to prefer equities over sovereign debt.

Euro area: a potentially promising shift in political balance
We could see a new political balance emerge in the spring with a heavier tilt toward European integration. It could continue the spirit of greater unity forged in the heat of the COVID crisis in 2020, and pave the way for progress on fiscal and financial union. This could in turn be good news for the economy in general and equity markets in particular, where prices still lag value.

Asia appeals - unlike other emerging markets
Emerging economies face mixed prospects for the coming year. China continues its slowdown and other regions are confronting *stagflation* (weak growth and high inflation). All of which is far from bullish for emerging markets. That said, we see some nice upside in Asia: assets still look cheap and, medium term, Asia is still the most dynamic of the emerging regions.

A strong dollar going into new year
With the US still growing faster than the rest of the world and mopping up most of the world’s savings-investment - something unlikely to change quickly - the dollar looks set to stay strong against most currencies in H1 2022.

Sector views on US and EZ equity markets
As 2022 is expected to be a transition year for the US business cycle phase, the cyclical sector may gradually benefit from fewer support factors, in favor of value stocks. In Europe, as the position in the cycle remains in the expansion phase, cyclicals should benefit first from this catch-up.
**DEVELOPED ECONOMIES: GROWTHFLATION WILL BE GOOD FOR EQUITIES**

**Recovery ploughs on** (cf. graph p.7)
Recovery should continue at a healthy pace in 2022 across the advanced economies, albeit slower than during the 2021 post-COVID rebound. Several helpful factors will continue to apply: companies look financially sound (see margins chart) and households have built up savings which should sustain consumer spending. Normalising labour markets and still accommodative monetary and financial conditions are other ongoing positives. The threat of COVID has not gone away, but the threat to mobility is receding, making it less of a drag on the economy. Greater vaccination and new treatments could also lessen the scope of its impacts.

**Transitory inflation that lasts** (cf. graph p.7)
Inflation is likely to top central bank targets for some months yet. Strong demand and constraints on supply are generating severe pressures on production chains and the spike in energy costs is pushing up input prices. These pressures should gradually ease over the course of the year, allowing inflation to fall back to levels more comfortable for central banks, who will then be able to take a gradual approach to normalising policy. But there is a real risk these pressures will persist, particularly in the United States, meaning monetary policies could tighten faster and further than expected. In the euro zone, price pressures are mainly due to external factors and the threat is more of weaker economic activity than of lasting higher inflation. The ECB will thus keep monetary policy accommodative.

**This stage of the cycle is good for equities and their relative returns** (cf. graph p.11)
The US economy will shift gear in 2022 from acceleration to cruising speed. The euro area, still playing catch-up, can continue to grow for some time. Based on historical performance in past US cycles (see chart below), 2022 is likely to be good overall for equity markets, even if yields will be less generous than in 2021.

Some stocks may look pricey, particularly in the US, but returns on equities will remain a lot more tempting than anything on offer in the bond markets (see charts). Interest rates will remain rock bottom or negative in real terms, whether you plug in today's headline inflation or the more modest rates anticipated for the medium term.

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**Risk premiums by economic regime**

![Risk premiums chart](chart_url)

*Sources: SGPB, Kleinwort Hambros, Bloomberg, Factset, annualised monthly returns from 1973 to 2019*
EURO AREA: A POTENTIALLY PROMISING SHIFT IN POLITICAL BALANCE

The euro area has managed COVID especially well, taking strong and coordinated political action across states, in stark contrast with its handling of other recent crises. But the path to economic recovery remains rife with challenges, and the continent's emerging political balance will be key to overcoming them. Initial noises from the German government have been clearly pro European construction. The new government could well mark a turning point, toward a more global policy positive for Europe, just as Europeans are recovering their confidence in the EU. This will obviously depend on what happens in the French and (perhaps) Italian elections in the first half of 2022, but could potentially prove a solid support for the economy short and medium term and for the zone’s still price-lagging equity markets.

Investing to sustainably boost future growth
(cf. graph p.8)

While Europe has managed the economics of the health crisis satisfactorily, once the crisis is over it will once again confront its structural issues, most notably the problem of slowing potential growth. A big issue will be finding new ways to invest that can restart productivity growth (notably by investing in digital) and speed up the energy transition. The New Generation EU stimulus package marked a step change in targeting investment on countries with smaller budgets. The upcoming debate on overhauling the Stability and Growth Pact will be key to heading off an economically harmful policy of fiscal austerity while recreating a framework to rein in excessive spending. The new German government is showing itself open to greater flexibility when it comes to the new rules. Its new coalition deal includes a rise in investment spending, particularly on the energy transition.

Strengthening banking and financial union (cf. graph p.7)

The fragmentation of euro zone financial markets has eased, particularly since 2019, with a resurgence in private intra-zone investment flowing into the bond markets. A driving factor here has been the ECB’s increased willingness to weigh into the markets, helping reassure investors it will do what it takes to manage risks of market dislocation within the single currency. Euro area countries need to keep working on the projects to strengthen financial union, essential to keep capital flowing smoothly throughout the EU. Early announcements by the German government have been promising on the work that needs doing to complete the Banking Union, proposing a reinsurance system to replace the controversial proposal of a European deposit guarantee scheme. On a parallel track, states need to make progress toward Capital Markets Union to better channel Europe’s ample stock of savings into productive investment. Looking past the impact on capital flows, progress on these fronts would in time relieve the European Central Bank of its ongoing pressure to counter the risks of fragmentation and give the bank breathing room to pursue its primary objective, containing inflation.

A pivotal year for equity markets (cf. graph p.11)

2022 could be good for the euro zone, bringing real advances on fiscal and financial integration. Good news for equity markets, particularly as they still seem to be lagging their US cousins in value terms (even after correcting for sector composition).
ASIA APPEALS - UNLIKE OTHER EMERGING MARKETS

In China, growth should continue to slow. In other emerging economies it looks set to stall or go into reverse. A pretty unpromising backdrop for emerging financial assets. Nonetheless, we see interesting upside for Asian assets.

Controlled slowdown in China will be good for Asian markets (cf. graph p.9)

China’s economy is set to slow significantly in 2022 as GDP growth is expected to drop below 5%. The first culprit is the restructuring of China’s property sector, which currently makes up nearly a third of the country’s GDP. The government has put through a raft of measures to damp down the property boom, like capping developers’ debt and tightening constraints on household home loans. We envisage little change in this thrust of economic policy as the authorities remain wedded the mantra that “housing is for living, not for speculation” and are showing themselves increasingly open to some degree of economic slowdown. Overall, this policy also suits their long-term plan to rebalance investment growth toward consumption and so move toward a less debt-intensive growth model.

Having said all that, we would still expect any such slowdown to be controlled and activity to pick up speed again from the second half of the year. For one thing, the government will likely take targeted measures, so as to prevent a disordered deleveraging of the sector. Also, private sector investment elsewhere (outside real estate) should continue to bowl along, encouraged by robust profits in industrial sectors and government-backed initiatives to promote the high-tech and energy transition sectors. Finally, China and the wider Asia-Pacific region will remain the most dynamic of the emerging markets and the only one to keep closing the GDP per person gap to the developed world.

Foreign currency financial assets in the Asia-Pacific region look attractive today, at current valuations. True, the region’s markets are likely to remain highly volatile at the start of 2022, but the Chinese authorities’ capacity to manage the slowdown and healthy medium-term economic outlook should over time support a rally in the price of these assets. The region is also a trail-blazer in several high-potential sectors, including new technologies and renewable energies, which should further shore up the value of local financial assets over the next few quarters.

Stagflation haunts other emerging markets (cf. graph p.9)

The outlook for the other big emerging economies is lackluster, with growth set to stagnate or, for some, go into reverse during 2022.

Emerging economies will face a far less favourable external environment. China’s slowdown is likely to hamper growth among commodity exporters. At the same time, the Fed monetary tightening is likely to weight on capital inflows towards EM, or even lead to outflows.

Meanwhile, several countries that rolled out stimulus packages and now face higher inflation are implementing tighter economic policies. These will likely remain in place in 2022. Finally, political risks such as the upcoming Brazilian elections in Q4 2022 and geopolitical risks (Russia, Ukraine, China, Taiwan) could keep volatility bubbling for emerging market financial assets.

On the other hand, in this sluggish environment, governments of the big emerging economies have little foreign currency debt and big exchange reserves. By mitigating the risk of foreign currency default, this increases the appeal of the yields on offer compared to the negative real yields paid in developed economies.
A STRONG DOLLAR GOING INTO NEW YEAR

With the US still growing faster than the rest of the world and mopping up most of the world’s savings-investment - something unlikely to change soon - the dollar looks set to stay strong against most currencies in H1 2022.

The second half of 2021 has been marked by a strengthening dollar (cf. graph p.10)
A striking feature of 2021, especially the second half, has been big gains by the dollar against all other currencies, gaining nearly 7% in H2 2021. Of the developed economies it performed best against the euro (up nearly 7.5%) and sterling (up 6%). Versus emerging market currencies, leaving aside the special case of the plunging Turkish lira, the dollar appreciated most against the CLP (up 16%) and BRL (up 6%) despite their local central banks hiking policy rates substantially in the year.

Savings imbalances favour the dollar (cf. graph p.10)
The dollar strength can also be analysed through the prism of international balances of savings and investment. Global imbalances have got worse since COVID hit. In Asia and Europe alike, current account surpluses - the surplus savings in a country that it ‘exports’ to invest abroad - have markedly increase. Reviving commodity prices, meanwhile, have been good for exporter countries, which now post either surplus savings or smaller deficits. The US current account, in contrast, has further deteriorated. This savings shortfall is linked primarily to a deepening trade deficit. The post-COVID bounce brought a rush of consumer spending which translated into strong imports growth, far above the level of exports. Overall, in a world where the United States is the only country running a current account deficit, most of Asia’s and Europe’s surplus savings are gravitating toward US investments.

In other words, a surplus of European and Asian savings is increasing the demand for US financial assets - particularly stocks and bonds - and supporting the demand for US dollars. These imbalances seem unlikely to change given the persistent vigour of the US economy. As the year wears on and the COVID crisis hopefully eases, consumption should turn increasingly toward home-made services reducing the share of exports in shopping baskets. The US current account deficit should therefore fall slightly in the second half of the year.

Stronger growth will continue to help the dollar early in the year
Driving the dollar's rise in 2021 were the disparities between the US economy and other developed economies in terms of growth, long-term interest rates and the prospect of faster monetary policy tightening by the Fed. All these trends should continue to apply in the early months of 2022. The US economy will continue to grow as fast as any in the developed world and emerging economies will lose vigour. The spread between short and long yields offered in the US and in other developed economies should widen further in the new year as the US tightens policy faster. But the gathering momentum of the euro zone economy from H2 2022 could gradually tilt the advantage away from the dollar and toward the euro.
**United States: growth still powered by new technologies** *(cf. graph p.11 and table p.12)*

US equities outperformed in 2021 in virtually all sectors, against a backdrop of surging company profits, strong nominal growth and negative real interest rates. In 2022, we expect i) the economy to continue to post a dynamic growth on the back of strong consumer demand, ii) the Fed to begin its rate tightening cycle but real rates to remain negative, and iii) companies to enjoy healthy balance sheets with plentiful cash. In such a climate, equity markets should continue their bullish trend. 2022 is set to be a transition year as the US economic cycle shifts from an expansionary to a moderating phase. Support factors could tilt away from cyclicals and toward value stocks.

**This scenario is good for:**
- **The high tech sector.** High tech giants earn much higher margins than the rest of the economy and are sitting on cash mountains. Also, as monetary policy tightens, investors will look increasingly toward what they see as ‘quality’ stocks.
- **The banking sector.** Banks usually do well in an environment of strong growth and rising rates, our scenario for 2022.
- **The renewable energies sector.** This sector should benefit from public sector investment and more favourable regulations.

**It could be less good for:**
- **Unicorns.** This group of companies with strong growth prospects but little or no profits could be hampered by a tighter monetary environment and fading growth.
- **Sectors with high wage costs.** Salaries should continue to rise in some industries, eating into the margins of companies with high payroll costs.

**Europe: prospects still bullish** *(cf. graph p.11 and table p.12)*

European shares have done well in 2021 as the economy bounced back, rates stayed negative and companies were able to post growing profits. In 2022, we expect the economy to continue its healthy growth as the post-COVID rebound continues and governments still deliver fiscal support. Monetary conditions should also remain favorable, with negative real rates, as the ECB tapers down progressively its asset purchases and inflation also falls back. Also, given these bullish factors, European shares look cheap in our view, particularly compared to the other side of the Atlantic. All of which leads us to think that the European equity market should continue to perform well. The euro area economic cycle is still in an expansionary phase and cyclicals should be best-placed to profit from this catch-up.

**This scenario is good for:**
- **The infrastructure and renewable energies sectors.** Both sectors should do specially well out of the European stimulus plan which earmarks much of its largesse for infrastructure and the energy transition. The latter sector also stands to gain from various pro-renewables regulations.
- **The new technologies sector.** Another potential winner from the European stimulus plan. Also, booming M&A in the sector and an influx of private equity funds should help pump up sector values.

**It could be less good for:**
- **Metals and miners.** China’s economic slowdown, particularly focused on the construction sector, is likely to dampen sector revenues.
- **Consumer goods and services.** This sector is likely to feel some squeeze as China's economy slows and the “common prosperity” policy comes in with stock prices already high.
The recovery is expected to remain dynamic in 2022 in the advanced economies, with lower growth than in 2021. Inflation would gradually ease.

Various factors will continue to be very favorable: the financial health of companies as well as households with high accumulated savings.
The potential for activity to catch up is greater in the eurozone. Cross-border debt purchases show a clear improvement in fragmentation.

The New Generation EU program will benefit Italy and Spain in particular. After several years of decline, public investment could increase.
Growth in China is expected to slow down significantly in 2022, but the medium-term outlook remains positive in a region that is continuing to catch up.

**China : GDP growth in volume and credit growth**

Despite a complicated economic context, bond yields in foreign currencies may become attractive again in view of the low level of foreign currency debt.

**Domestic credit impulse**

% of GDP, sum of primary deficit and 1 year change of credit to private sector

**USD sovereign spreads**

Bps, vs US 10y

Sources: SGPB, Macrobond, IMF 2026
The appreciation of the dollar in 2021 was supported by the interest rate differential. This spread should continue in 2022.

The widening of international imbalances has favored the dollar, with significant demand for US assets.
The low interest rate and high inflation environment will continue to make expected returns on equity markets particularly attractive.

Eurozone equity markets appear attractive, even after adjusting for sectoral composition effects.
### TABLE: EQUITY MARKET

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<th>MSCI sector weights</th>
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Source: SGPB, TS Lombard, 14/12/2021
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