Global Asset Management
BlueBay Asset Management

2022 Outlook: Inflection Point

Summary

Investors face an inflection point with the pandemic marking the end of the 'lowflation' era of low growth, low inflation and low interest rates. The new regime is one that we believe will be characterised by more interventionist governments, a populist shift favouring labour over capital and increasing intensity regarding climate change and decarbonisation, with greater macroeconomic uncertainty and market volatility.

The Covid-19 pandemic and policy response to it has dominated the global economic and investment landscape since 2019. In 2021, the roll-out of highly effective vaccines allowed economies to re-open, underpinning a V-shaped (but incomplete and uneven) global recovery, despite further waves of infection. Inflation is surging as the rebound in demand outstrips supply, which remains constrained by Covid-related disruptions.

Huge levels of government borrowing, required to support businesses and household incomes through the pandemic, were funded by a surge in private sector savings, and underwritten by central bank bond buying and record-low interest rates. Excess private savings have been recycled into financial assets, including government bonds, and have driven nominal yields below actual and expected inflation. In turn, negative real yields have underpinned positive returns across nearly all financial assets since the outbreak of the virus, despite global economic activity remaining below its pre-pandemic path.

We are forecasting another year of above-trend global growth, supported by rising investment levels and healthy consumer demand. Less saving and higher investment will put upward pressure on real yields and downward pressure on risk assets.

Key highlights

- We forecast another year of above-trend global growth, supported by rising investment levels and healthy consumer demand.
- An easing of Covid-related supply disruptions should moderate global inflation, but we expect it to remain above central bank targets.
- Expect to see continuing volatility from bond markets caught in a tug of war between the evolution of Covid infections, persistently higher inflation, ongoing economic recovery and dovish central bank policy shifts.
- We believe investors will benefit from drawing on alternative sources of return, as well as favouring global and sustainable investment strategies and placing greater reliance on smart asset allocation and security selection.
- In our view, there is some room for further modest spread compression between investment grade and high yield credit spreads.
- Bank subordinated debt looks well placed to perform as banks benefit from higher rates and volatility, while still solid economic growth will be reflected in improving asset quality and loan growth.
- Credit returns are likely to be modest, although sector and rating dispersion should provide opportunities for generating excess returns. We believe short duration strategies, such as convertible bonds as well as leveraged loans and collateralised loan obligations (CLOs), will likely outperform.
- As Covid-19 fades and economies continue to recover, along with a stabilisation in the outlook for inflation, international investors are likely to increasingly turn their attention to attractive valuations in emerging market local debt.

A shift in consumer demand from goods to services and an easing of Covid-related supply disruptions should moderate global inflation, but we expect it to remain above central bank targets. The notion of 'lower for longer' with only a modest rise in policy rates, especially from the US Federal Reserve (FED), will be challenged in 2022.

The emergence of a new variant of concern, Omicron, is a further source of uncertainty for the global economy and markets. Widespread and prolonged lockdowns are unlikely, in our view, and economic activity has become more resilient to periodic 'waves' of infections. Nonetheless, Omicron has increased complexity around our macro forecasts and investment view. On the downside, if Omicron proves more infectious and resistant to existing vaccines than the currently dominant Delta variant, global growth will be much lower than forecast. In an upside scenario, Omicron is more infectious but less severe and the Covid burden eases quickly, with higher global growth and inflation than in our baseline forecast. Either way, Covid will remain a source of uncertainty.

Investors also face potentially treacherous global macro crosscurrents in 2022. Solid growth in economic activity and corporate earnings must be weighed against the inflection in global monetary policy and the risk that higher and more persistent inflation prompts central banks to press down harder on the monetary brakes. Rising nominal and real yields will render many assets with valuations at or near historic highs vulnerable to negative news on growth and earnings, whether it be a resurgence of the virus, a Chinese 'hard landing', climate change or other ESG challenges.

Investors face an inflection point with the pandemic marking the end of the 'lowflation' era of low growth, low inflation and low interest rates. The new regime is one that, in our view, will be characterised by more interventionist governments, a populist shift favouring labour over capital, increasing intensity regarding climate change and decarbonisation with greater macroeconomic uncertainty and market volatility.

We believe investors will benefit from drawing on alternative sources of return and diversification, such as illiquid emerging market credit and distressed debt, as well as favouring global and sustainable investment strategies. Disciplined risk management and supplementing what are likely to be more modest (and volatile) market returns with greater reliance on smart asset allocation and security selection will be key.

"We are forecasting another year of above-trend global growth."

Fast forward

The deepest – and shortest – global recession on record was followed by one of the fastest recoveries. 2021 was characterised by a V-shaped rebound in activity as vaccines allowed societal re-openings and global output reached its pre-pandemic (2019) peak. The economic impact of Covid infection waves is diminishing due to higher immunity and resilience. Despite the recent upturn in Delta infections (and the emergence of Omicron), global growth is re-accelerating into year-end, setting 2022 up to be another year of above-trend global growth.

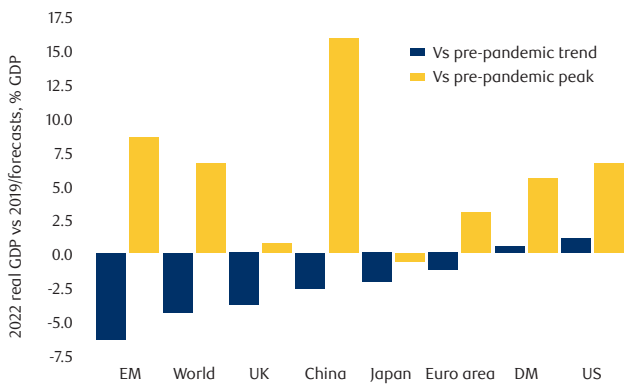
Despite the strength of the recovery, it is incomplete and uneven with emerging markets ex-China lagging behind, alongside demand for services. Global growth is forecast to slow from around 6% in 2021 to 4.5% in 2022, which while being above trend, will still leave the global economy some 4% smaller at year-end than was forecast prior to the pandemic.

A notable exception is the US. Here, the economy is expected to be bigger in 2022 than forecast prior to the pandemic, underscoring the exceptional fiscal and monetary stimulus that we have seen come out of Washington.

Our confidence in above-trend growth in 2022 rests on four factors:

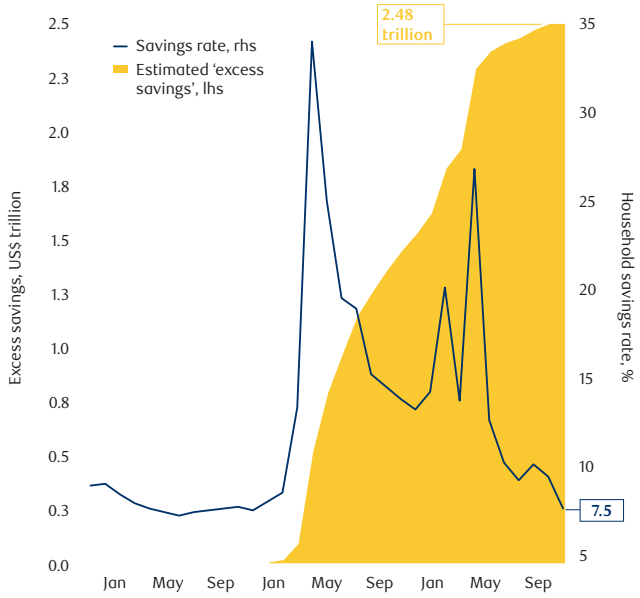
- The health and resilience of the consumer.
- A shift in spending from goods to services.
- Higher investment and inventory restocking.
- Policy easing in China.

Fig. 1: Output in 2022 versus 2019 & pre-pandemic forecasts



Note: difference between BlueBay Asset Management forecasts for real GDP in 2022 and 2019 real GDP and IMF forecasts for 2022 published in October 2019.
Source: BlueBay Asset Management forecasts and estimates; IMF October 2019.

Fig. 2: US 'excess savings'



Source: Macrobond; BlueBay Asset Management estimates; latest data for September 2021.

Household and corporate balance sheets are in good shape and should support demand despite the drag from less fiscal support. There are still gains to be had from re-openings in Europe and emerging market economies and financial conditions will remain growth-friendly even as central banks raise interest rates.

Fig. 3: Global investment tracker

Source: BlueBay Asset Management estimates; latest data for September 2021.

Global growth risk factors

The key downside risks to our broadly benign outlook for global growth are:

- A sustained slowdown in China led by the property market.
- High and rising inflation increases the risk that central banks are forced to slam on the monetary brakes with the attendant risks to growth into 2023.
- Renewed Covid-19 outbreaks (notably Omicron at the time of writing) and the associated downside risks of dampened demand and further disruption to global supply chains.

A key underpinning of our global growth forecasts is that Covid-19 transitions from pandemic to endemic, where the spread of the virus is contained such that it does not overwhelm health services. If Omicron proves to be more vaccine-resistant and becomes the dominant variant, the negative impact on global growth could be sizeable (a guess-estimate is between 0.5 to 1 percentage point).

On the upside, the faster distribution of vaccines worldwide – and even Omicron proving highly infectious but with mild symptoms – would see a faster return to 'normality', boost consumer spending and ease supply constraints and associated inflation pressures.

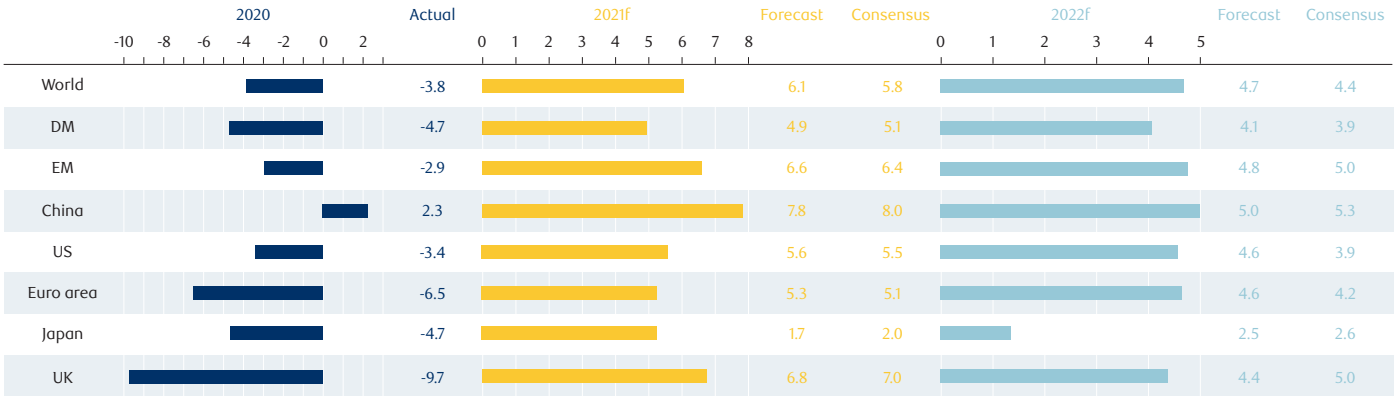
In our view, the risk to the outlook is broadly balanced. The evolution of the virus, vaccines and policy will remain

key drivers of the global economy and financial markets through 2022.

2022 will be characterised by above-trend growth and above-target inflation. But by the end of the year, we expect the global economy will exhibit mid-cycle and even late-cycle characteristics with growth decelerating as economies reach full employment and interest rates move higher.

The outlook beyond 2022 is inevitably clouded by greater uncertainty, but a return to the 'Great Moderation' of low growth, low inflation and low interest rates with little of the macroeconomic volatility that characterised the pre-pandemic period appears a distant prospect.

Fig. 4: Global growth forecast (annual % change)



Source: Consensus forecast as reported by Bloomberg; BlueBay Asset Management forecasts; 30 November 2021.

Inflation higher for longer

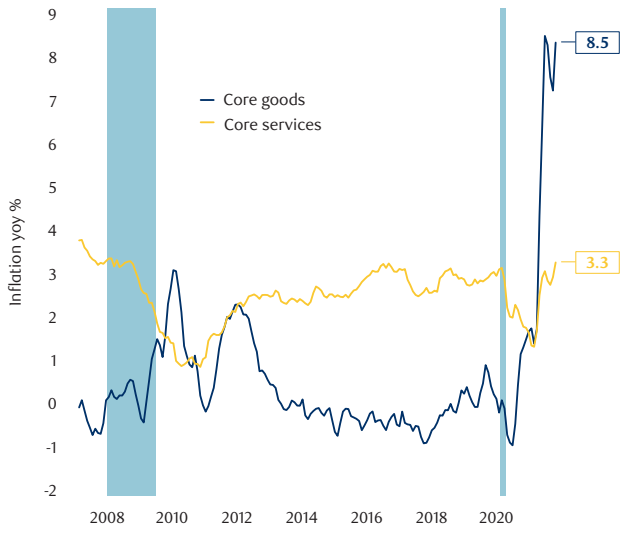
Inflation pressures have built quickly as demand has out-paced supply. In part, this is due to the unusual nature of the recovery with a surge in demand for goods, especially from US consumers, exceeding supply capacity of just-in-time global manufacturing, which remains subject to Covid-related disruptions.

Consequently, goods prices have soared after years of disinflation. This is well illustrated by the auto sector. Demand for new vehicles is high, yet production has fallen due to microchip shortages, resulting in a surge in used car inflation.

The mismatch between supply and demand is also apparent in labour markets, which have record vacancy levels set against above-pandemic levels of unemployment and a smaller labour force.

Goods inflation pressures will moderate in 2022 as consumer demand shifts towards services and supply constraints ease. But with the US economy 'running hot', the unemployment rate set to fall below 4% and rising input costs (including from wages), US inflation pressures will broaden and remain elevated. In addition, robust house price appreciation is feeding into higher shelter costs. We expect core US inflation to average above 4% in 2022.

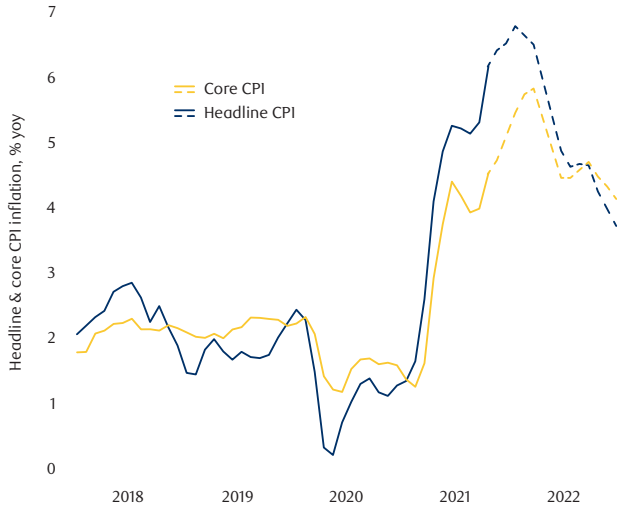
Fig. 5: US core goods vs services inflation



Source: US Bureau of Labor Statistics; latest data for October 2021.

Our forecast is meaningfully above consensus at around 3.5% for core CPI inflation. This reflects our view that with the US economy running above full capacity, underlying inflation pressures will rise and offset much of the decline from an easing in Covid-related supply disruptions.

Fig. 6 US headline & core inflation forecast



Source: Macrobond; BlueBay Asset Management forecasts; latest actual data for October 2021.

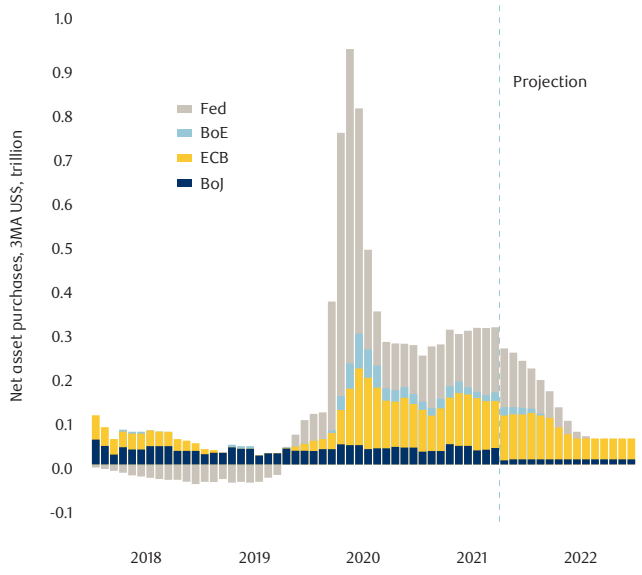
While demand/supply mismatches are less acute across other major economies, higher energy and commodity prices, as well as robust growth, will mean inflation remains above central bank targets.

Higher inflation from the supply/demand dislocations caused by Covid-19 and the policy response will fade as the virus graduates from pandemic to endemic. But deglobalisation, a greater focus on more 'resilient' (localised) production chains, alongside political and demographic shifts favouring labour over capital are trends that have been accelerated by the pandemic and subsequent policy responses. Technology remains a powerful disinflationary force, but public and political sentiment is shifting against unfettered innovation that is perceived to threaten jobs and widen social inequalities. More frequent extreme weather events and the transition to a carbon net-zero economy will also be sources of inflation volatility and higher prices. In our view, the Covid-19 crisis marked the end of the 'lowflation' regime of the last decade.

The rocky road to higher interest rates

Persistently above-target inflation and rising inflation expectations are challenging the 'transitory' narrative that underpins central banks' forward guidance for very gradual monetary tightening. Volatility in short-term interest rate markets has risen and is likely to stay elevated in 2022 as central bank bond buying declines and incoming economic data, especially on inflation, dominates forward guidance.

Fig. 7: G4 central bank asset purchases



Note: based on announced policies and assumption that ECB PEPP will conclude in March 2022 partially offset by EUR20bn increase in APP to EUR40bn per month.
Source: Macrobond; BlueBay Asset Management estimates and projections; latest actual data for October 2021.

Despite some push back from central banks, markets have brought forward the 'lift-off' in policy rates for major central banks, including by the Fed. But even as investors anticipate somewhat earlier rate rises, the expected hike path remains gradual by historical standards and the endpoint of the rates cycle – the terminal rate – and long-end yields have not moved much higher.

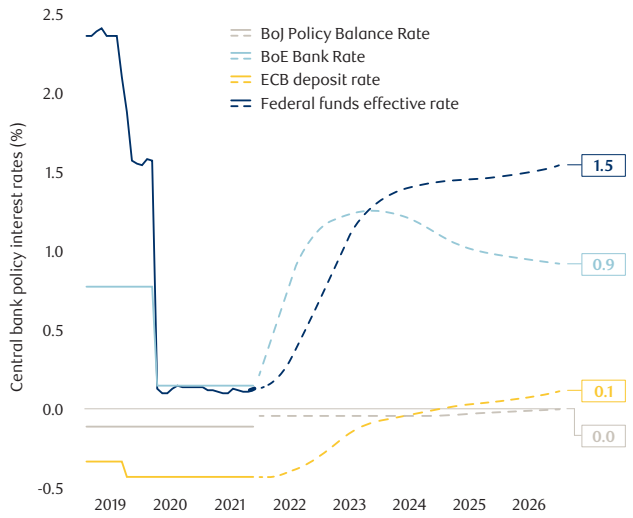
Underlying inflation pressures in the euro area are not as acute as in the US (and UK), despite the recent spike in headline inflation. The ECB will wish to avoid a premature tightening, given that it is at the effective lower bound for policy rates. We expect the ECB to offset the end of the Pandemic Emergency Purchase Programme (PEPP) in March 2022, with at least a doubling of bond purchases under the Asset Purchase Programme (APP) to EUR40 billion per month with modest rate increases from mid-2023 at the earliest.

The current market-implied path of the Fed funds rate is for 'lift-off' in the second half of 2022. The conclusion of quantitative easing (QE) tapering will be followed by four to five 25 basis points (bps) hikes by the end of 2023, taking the rate to around 1.25%. The current market-implied terminal rate for Fed funds is around 1.50% to 1.75% – well below the Fed's 2% medium-term inflation target and the Fed's own belief that the 'neutral' (long run sustainable real interest rate) is above zero.

In our view, with inflation likely to be well above 4% through 2022 and unemployment below 4%, once the Fed starts to raise interest rates it will go faster and further than currently reflected in market pricing and Treasury bond yields.

The Fed and the ECB have become more inflation-tolerant following recent policy framework reviews. The risk is that inflation proves more persistent than expected, especially in the US, and inflation expectations of households and businesses continue to drift higher, forcing a harder application of the monetary brakes.

Fig. 8: Market Implied path of short-term interest rates



Note: market-implied path derived from OIS forward curves reported by Bloomberg at at 15 November 2021.
Source: Macrobond; Bloomberg; latest actual data at 15 November 2021.

The falling trend rate of underlying economic growth, a rise in public and private debt and an aging population underpin the secular decline in real (inflation expectations adjusted) interest rates and core government bond yields. The Covid-19 crisis marked a further step down in global real yields that, in our view, is not warranted by economic fundamentals. There is little evidence of long-term economic 'scarring' from the pandemic that has meaningfully lowered long-term global growth potential and the 'neutral' policy rate. Public debt is much higher post-pandemic, but corporate leverage (debt to earnings) has recovered to its pre-pandemic level and household balance sheets have improved (while acknowledging the significant variation across household incomes).

In our view, real yields stayed deeply negative through 2021 despite higher inflation and expectations for central banks to hike rates sooner rather than latter because of excess savings and liquidity – this was the flipside of the extraordinary fiscal easing effectively funded by central bank bond buying. However, household savings rates are falling to pre-pandemic levels and we expect some drawdown on the 'stock' of excess savings accumulated during the pandemic (implying savings rates dropping below their pre-pandemic rates for a period). Government dissaving will fall as budget deficits decline along with central bank bond purchases, while capex and housing investment are rising.

In other words, excess savings and liquidity are set to become less acute in 2022 and along with a rising term premium and upward re-pricing of policy rates, we expect real yields to move higher.

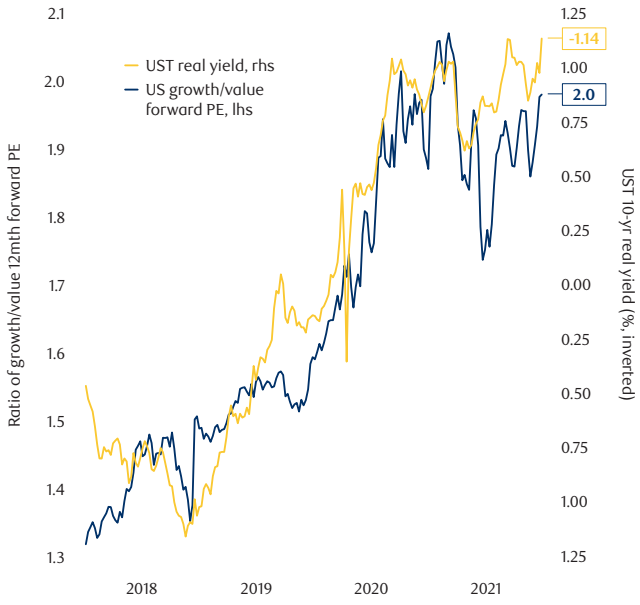
"Once the Fed starts to raise interest rates it will go faster and further than currently reflected in market pricing and Treasury bond yields."

Treacherous crosscurrents

Investors should expect continuing volatility from bond markets caught in a tug of war between the evolution of Covid infections, persistently higher inflation, ongoing economic recovery and dovish central bank policy shifts. There will also be meaningful divergence between central banks and in the monetary policy outlook, reflecting differing recovery and inflation paths and policy reaction functions. While core fixed income benchmarks will likely post another year of negative returns in 2022 as bond yields rise, volatility and cross market relative value provide active investors with a potentially rich opportunity set to generate positive returns.

Negative and relatively stable real yields on core and US long-end government bonds is the foundation for ultra-easy financial conditions. This is underpinned by the resilience of growth-sensitive risk assets, notably long-duration 'growth' equities, despite macro uncertainty and volatility in short-term interest rate markets. But with rising nominal and real yields and equity valuations, high by historical standards after double-digit returns since 2019, the outlook for risk assets is more challenging going into 2022 despite our relatively optimistic growth forecasts.

Fig. 9: US TIPS real yield & US growth/value forward PE



Source: Bloomberg; latest data at 15 November 2021.

Carry on

Higher and more volatile core rates and range-bound equities will be headwinds for high yield credit, counter-balanced by improving credit fundamentals. Many non-dedicated investment managers have reached for yield in sub-investment grade corporate credit, especially in the US. If higher rates generate negative total returns, these inflows could reverse and be a source of volatility in credit markets.

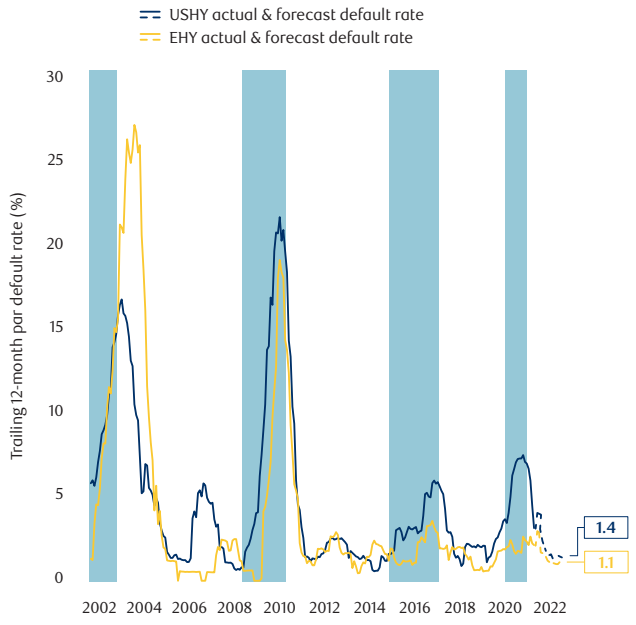
While the business cycle is maturing at a rapid rate, the credit cycle is proceeding at a more leisurely pace. For the cycle to turn, capital typically needs to be exposed to a negative economic shock, prompting a meaningful re-rating higher of default expectations and credit losses. While there are signs of 'excess' in leveraged loan and private credit markets (more aggressive leveraged-buyout and dividend recap financing and high and rising equity multiples in private credit), in public credit markets, issuer leverage is declining.

Very low actual and expected defaults and improving credit fundamentals (declining leverage and positive rating trends) are to a large extent already reflected in valuations. US credit spreads are near their post global financial crisis tights and euro credit spreads sit in the lowest quartile over the last five years. In contrast, emerging hard currency corporate credit spreads are broadly in the middle of their longer-term range.

In our view, there is some room for further modest spread compression between investment grade and high yield credit spreads. Against a favourable growth and fundamental backdrop, spread tightening will partially offset the negative impact of higher rates on total returns. Bank subordinated debt looks well placed to perform as banks benefit from higher rates and volatility, while still solid economic growth will be reflected in improving asset quality and loan growth.

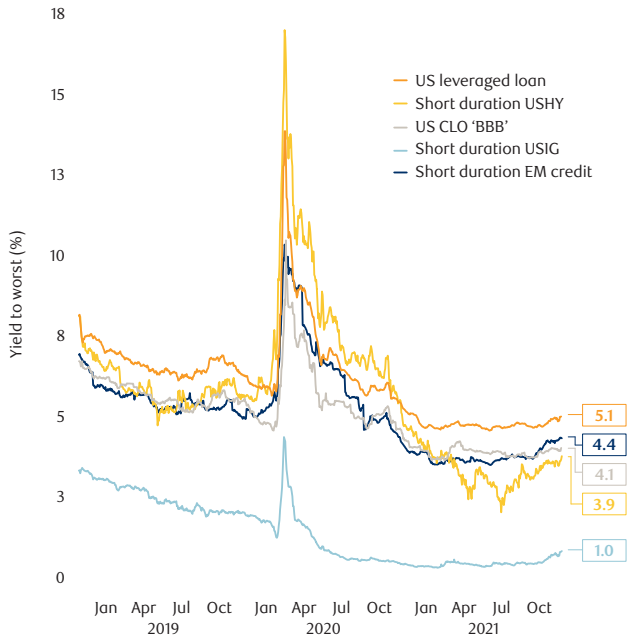
Credit returns are likely to be modest, mostly from clipping coupons and carry, although sector and rating dispersion should provide opportunities for generating excess returns. We believe short duration credit, such as convertible bonds as well as leveraged loans and collateralised loan obligations (CLOs), will likely outperform.

Fig. 10: Forecast high yield default rates



Note: shaded columns denote trough to peak in trailing 12-month default rates.
BlueBay forecasts based on distress ratios.
Source: BoA; BlueBay Asset Management forecasts; latest actual data for October 2021.

Fig. 11: Short duration credit yields



Note: 1-3 year maturity credit. Source: Bloomberg; JP Morgan; latest data at 15 November 2021.

Emerging markets: Unloved and under-valued

2021 proved a challenging year for emerging market assets despite the recovery in global growth, international trade and commodity prices. Initially, less access to and the slower rollout of vaccines hindered the recovery across many emerging countries. The credit and regulatory tightening in China, alongside financial distress among property developers, also weighed on emerging market assets. But the key global macro headwind has been a stronger US dollar and higher interest rates in response to rising inflation.

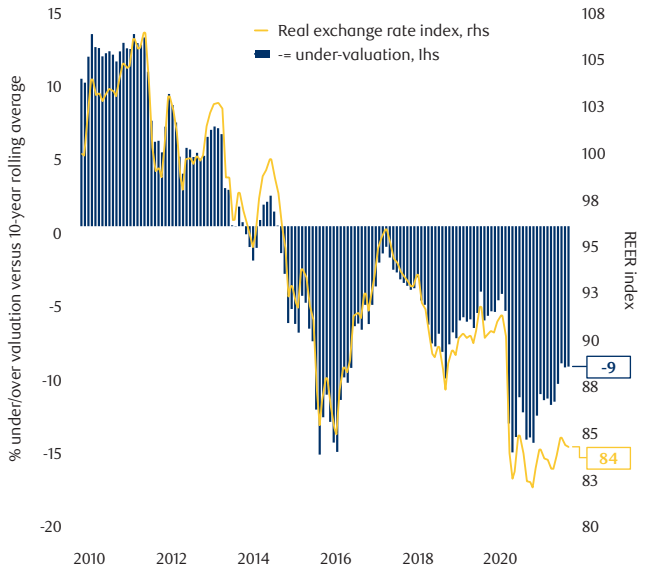
Local interest rates in emerging markets sold-off more aggressively in 2021 even relative to the taper tantrum episode in 2013, resulting in historically wide nominal and real yield differentials relative to developed market rates. Market pricing implies further rate hikes and terminal rates at or even above prior cycle peaks. Emerging market central banks have generally been proactive in reacting to higher inflation, on worries that inflation expectations could become unanchored and their hard-won policy credibility tarnished. Despite rising rates and improving current account balances, emerging market currencies depreciated and, in aggregate, are at multi-year lows.

As Covid-19 fades and economies continue to recover along with a stabilisation in the outlook for inflation, international investors are likely to increasingly turn their attention to the attractive valuations in emerging market local debt.

In terms of hard currency emerging market debt, 2021 was characterised by a widening in the gap between investment grade and high yield sovereign and corporate credit. The legacy of the pandemic has left several low-rated sovereigns with fiscal funding needs as well as weaker economies, for instance from the collapse in foreign tourist receipts. Emerging market corporates have generally weathered the pandemic relatively well with earnings recovering and leverage falling back to pre-pandemic levels. Ex-China, the emerging market corporate high yield default rate is expected to be below 2% in 2022.

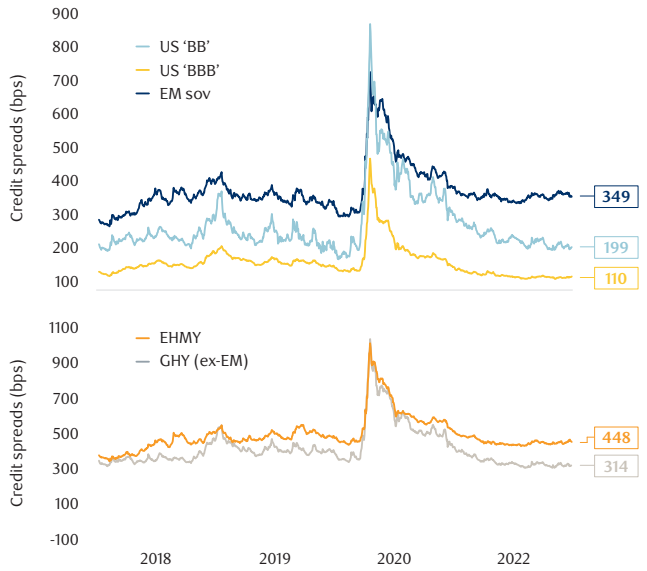
Emerging market assets will continue to be buffeted by global macro headwinds, but over the medium-term, offer the prospect of higher returns based on younger faster-growing economies and attractive valuations.

Fig. 12: Average emerging market real effective exchange rate



Note: Average emerging market real (inflation-adjusted) effective exchange rate and deviation from rolling 10-year average.
Source: BIS and BlueBay Asset Management estimates; latest monthly data for September 2021.

Fig. 13: EM versus DM sovereign & corporate credit spreads



Note: DMHY = BoA Global High Yield e~Emerging Markets (HYDC); EMHY = JP Morgan CEMBI Broad US 'BBB' & US 'BB' = Bloomberg US Corporate & High Yield indices; EM sov = JP Morgan EMBI Globa.
Source: JP Morgan; Bank of America; latest data at 15 November 2021.

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David joined BlueBay in September 2013 and is Partner and Chief Investment Strategist within the Chief Investment Office. He is a member of BlueBay's asset allocation team that manages some USD6 billion of multi-asset credit strategies. David chairs the weekly Investment Forum of BlueBay's portfolio managers, as well as the monthly Corporate Credit Group.

Drawing on more than 20 years of applied macroeconomic, policy and sovereign credit experience, David offers investment insights as well as developing and articulating BlueBay's broad macro and corporate credit views.

David was previously global head of Fitch's Sovereign and Supranational Group, responsible for more than 130 ratings of the world's largest fixed-income issuers. Prior to Fitch, David was a senior economist at UBS Investment Bank and at HM Treasury where he advised on international economic and debt issues, including representing the UK at international debt restructuring negotiations at the Paris Club of Official Creditors.

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