



2022 Global Market Outlook

Playbook for a shifting
economic landscape



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Capex revival on global green revolution

Global corporations appear to have ample resources to finance fixed investment thanks to strong earnings, spending restraint amid the pandemic and a surge in low-cost borrowing.

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Introduction

After consecutive years of strong performance for most equity and credit sectors, T. Rowe Price's investment leaders urge greater selectivity in 2022, as global market prospects appear more uncertain.

While the omicron variant – and the possibility of renewed lockdowns – are still threats, the primary economic focus for 2022 has shifted to the risks that higher inflation and interest rates could pose for growth and asset returns. However, on the positive side, household wealth gains, pent up consumer demand, and a potential boom in capital expenditures, could sustain growth – even as monetary policy turns less supportive.

In the below view for 2022, Sébastien Page, Head of Global Multi Asset, Justin Thomson, CIO and Head of International Equity, and Mark Vaselkiv, CIO Fixed Income, highlight the key factors driving global markets and the actionable insights needed to navigate the shifting economic landscape.

Recovery can overcome inflation and omicron

By Sébastien Page, Head of Global Multi-Asset, Justin Thomson, CIO and Head of International Equity, and Mark Vasselkiv, CIO Fixed Income

The question is whether global consumers will convert their improved financial positions into higher spending.

ACTIONABLE INVESTMENT SNAPSHOT

We currently have a balanced view on equities. While global economic growth could slow, it should remain relatively strong – but inflation is a headwind. This suggests a broadly cautious approach, which could favour durable businesses with reasonable valuations. In fixed income, we prefer shorter-duration and inflation-linked securities, as elevated inflation and central bank tightening could make longer-duration bonds unattractive. In addition, with real rates so low, we have to acknowledge bonds may not diversify stocks as well as in the past. The 60/40 portfolio needs to be re-optimised for the current environment.

Despite headwinds from the pandemic, the global economic recovery still appears on track – but inflation risks have risen. In 2022, investors will need to watch what fiscal and monetary policymakers do to try to stem price pressures while sustaining growth.

Although the emergence of the highly mutated omicron variant is a reminder the pandemic is still with us, the net economic effect of past waves – such as the spread of the delta variant – has been to postpone activity, not prevent it. This pattern could give a modest boost to growth in the first half of 2022.

The bearish economic case now centres on monetary and fiscal policy. As governments and central banks withdraw the massive stimulus applied during the pandemic, economic growth inevitably will slow sharply – or so the argument goes. But slower growth does not necessarily mean low growth. There are number of tailwinds able to sustain the recovery in 2022.

Potential surge in pent-up demand

For example, consumers are in a strong cash position, especially in the US, where more than US\$2trn is sitting in checking accounts and other short-term deposits. In addition, asset appreciation has boosted household wealth both in the US and globally, while pent-up demand for housing should continue to fuel new home construction. Finally, corporate balance sheets generally are in strong shape, with high liquidity and low debt ratios, and transportation bottlenecks appeared to ease in late 2021, as seen by a sharp drop in global seaborne shipping costs.

The question is whether global consumers will convert their improved financial positions into higher spending. Assuming pandemic disruptions remain relatively manageable, there is potential for a surge in pent-up demand in 2022 for travel, entertainment, and other ‘quality of life’ services – as well as for new cars, as auto production normalises. With interest rates still low and banks eager to put deposits to work, loan growth also could drive consumer demand.

But the same factors potentially supporting growth could also prolong the sharp upswing in inflation seen in the second half of 2021. Unless pandemic conditions deteriorate significantly, improving global supply chains and factory reopenings could ease the upward pressure on prices in 2022.

Much of the 2021 inflation surge was concentrated in specific products – such as used cars and gasoline – that were particularly hard hit by supply/demand imbalances. The hefty price hikes in these goods seen in 2021 are unlikely to be repeated in 2022.

Risk of longer-term structural inflation

The bad news is prices for many other key items – such as some foodstuffs, rent, apparel, and airfares – have lagged broader inflation. As higher energy costs and the appreciation in home prices ripple through the economy, price increases for these goods are likely to play catch-up. Rents, in particular, appear poised to accelerate in 2022.

In addition, rising wages could present a longer-term structural inflation risk. While faster income growth should help support consumer spending, it could contribute to a wage-price spiral as businesses pass along higher costs – in turn putting more upward pressure on wages. If inflation starts to permeate into wages, and this starts to drive inflation expectations, maybe inflation will not be as transitory as we thought.

Demographic and labour market trends could heighten that risk. Occupations in a number of key sectors – including transportation, health care, and education – are seeing a wave of retirements, or soon will, as the baby boomer generation passes out of the workforce.

Meanwhile, large companies with deep pockets, such as Amazon, can afford to raise wages aggressively to attract the workers they need. Other service industries and smaller companies could be hard pressed to compete. Profit margins have been very high for very long. But now the pendulum is swinging from capital to labour.

Equity enigma as stocks both expensive and cheap

By Sébastien Page, Head of Global Multi-Asset and Justin Thomson, CIO and Head of International Equity

“Slowing earnings momentum is also likely to produce more uneven results across companies, requiring investors to be more selective.”

ACTIONABLE INVESTMENT SNAPSHOT

As mentioned, while stock valuations are elevated globally, they appear more reasonable in some ex-US markets. Amid slowing US earnings growth, markets with greater exposure to cyclical industries and global trade could benefit – particularly Japan and within EM. In addition, high-quality value and small-cap equities appear to hold valuation advantages. Unleashed demand could provide a tailwind for these companies, while operating leverage appears supportive for earnings growth.

Global equity markets demonstrated resilience in 2021, although the rise of the omicron variant put a dampener on optimism as the year drew to a close. In 2022, the question is whether earnings growth will continue to support US equity valuations that appear stretched in absolute terms.

Although signs of speculative excess abounded in 2021 – in areas like cryptocurrencies and non-fungible tokens – the US stock market currently does not appear to be in bubble territory. However, equity valuations are a bit of a puzzle.

As of mid-November 2021, the price/earnings (P/E) ratio on the Russell 3000 Index was almost at the top of its historical range since 1989. However, relative to real – or after-inflation – bond yields, the index's earnings yield was in the least expensive percentile over the same period. US stocks look almost as expensive as they have ever been, but also almost as cheap as they have ever been – and both statements are technically correct if you look through the right lens.

Earnings growth to dictate direction

Much will depend on the strength of earnings growth in an environment where the spread of coronavirus variants and the potential for rising interest rates both pose significant – if contrary – risks to the global economic recovery.

Throughout most of 2021, US equity gains were supported by a steady stream of upward earnings revisions. Despite a nearly 23% rise in the S&P 500 Index in the first 10 months of the year, the index P/E actually fell over that same period as earnings rose faster than stock prices.

If the recovery remains on track, earnings growth should continue in 2022. But with S&P 500 operating margins at a record level, US earnings momentum is likely to slow. With the starting point for profitability very high, it will be a hard hurdle to beat. Beyond 2022, the hurdles look even tougher to clear. The next two to three years could be very difficult from an earnings growth perspective. At a minimum, we could well see below-normal growth – but the stock market simply has not factored this in.

Slowing earnings momentum is also likely to produce more uneven results across companies, requiring investors to be more selective. This creates opportunities for active portfolio managers to add value for clients. Likewise, rising costs could put a premium on stock selection skill – as companies able to pass through inflation should continue to see earnings growth, but companies lacking pricing power could face issues.

Going global in search of alpha

While some US industries, such as aerospace, airlines, hotels, and cruise lines, have lagged in the earnings recovery so far – potentially leaving room for positive momentum – they account for relatively small shares of S&P 500 capitalisation.

The earnings picture for ex-US equities is more mixed. While earnings growth has been surprisingly strong in Europe, momentum in Japan has been slowed by a sluggish domestic economy. In 2022, Japan could offer relative valuation opportunities if the global recovery remains on track – as could equities, credit, and currencies in select emerging markets (EM). A contrarian case can also be made for Chinese equities, as Beijing moves to restimulate an economy appearing close to stall speed.

In addition, valuation fundamentals and cyclical factors could favour the 'recovery trade' in 2022. Financial stocks, which carry a heavy weight in the value universe, have historically tended to outperform in a rising interest rate environment – while small-cap stocks have typically done well during economic recoveries.

Finally, in a period of rising rates and higher inflation, the growth style could underperform. This could have implications for key growth sectors – technology in particular – that have led equity markets for much of the past decade. Companies able to grow earnings persistently over a long period of time are extremely rare. Therefore, the odds technology will continue to be a dominant sector are rather low.

Credit paradise cannot persist forever

By Mark Vaselkiv, CIO Fixed Income, Sébastien Page, Head of Global Multi-Asset and Justin Thomson, CIO and Head of International Equity

“So far, the Fed’s go slow approach to tightening has avoided a repetition of the 2013 taper tantrum.

ACTIONABLE INVESTMENT SNAPSHOT

We favour credit risk over duration in a rising interest rate environment. High yield bonds and floating rate bank loans offer attractive relative yields and shorter durations, with strong fundamental support. In addition, valuations in EM corporate debt markets, particularly in Asia, appear more reasonable than in other global credit sectors – especially as the Chinese economy could be poised to reaccelerate in 2022.

With inflation emerging as both a leading investment risk and a hot political issue, a turn toward higher interest rates appeared to be underway as 2021 ended. Yet, with Covid-19 still clouding the outlook, global central banks were moving at different speeds.

As usual, the Fed holds centre stage. As of late 2021, market expectations were rising that the Fed would begin tapering its quantitative easing bond purchases at a faster pace early in 2022. But there may be a disconnect between investor perceptions of Fed policy and the inflation expectations priced into fixed income yields.

Many investors came to the conclusion in the second half of 2021 that Fed Chairman Jerome Powell was being ‘irrationally dovish’ in continuing to focus on US unemployment even as inflation accelerated. But market indicators as of mid-November 2021 were reflecting a less bearish view. The markets – as reflected by long-dated rates or treasury inflation protected securities (TIPS) – seemed to be saying inflation was transitory.

On the cusp of a policy error?

A key question could be whether market expectations are compatible with the Fed’s 2% long-term inflation target. While this target is flexible, five-year break-even rates – the spread differential between yields on TIPS and on regular treasuries with equivalent maturities – as of mid-November 2021 suggested the market was anticipating 3% US consumer inflation over the next five years. So far, the Fed’s go slow approach to tightening has avoided a repetition of the 2013 taper tantrum. But it looks increasingly out of step with the inflation fundamentals. The probabilities of major policy mistakes are very high.

We see two potential interest rate scenarios for 2022. First, the Fed remains too dovish for too long, causing the yield curve – the spread differential between short and long-term treasury yields – to steepen. This could push the benchmark 10-year US treasury yield above 2%. Second, the Fed is forced to raise rates faster – and possibly higher – than markets expect. In this scenario, the yield curve could flatten and the 10-year treasury yield

could fall as investors begin to anticipate a negative shock to growth.

While continued strong economic growth and inflation could potentially pose significant risks for US treasuries and other low-yielding sovereign sectors in 2022, they have produced something close to ‘nirvana’ for global credit investors.

Quality could begin to deteriorate

Recent indicators of corporate credit quality reflect that blissful state, with the default rate on floating rate bank loans below 1%, as of mid-November 2021, and an upgrade/downgrade ratio among US high yield issuers approaching 1.8-1. Floating rate bank loans could offer particularly attractive opportunities in a rising interest rate environment, because the rates typically reset every 90 days, which is the shortest duration of any credit sector.

However, history suggests ideal credit conditions do not last forever. The dynamics supporting credit quality – ample liquidity, solid earnings growth, low balance sheet leverage – could also facilitate a shift to riskier financial practices. Credit quality could begin to deteriorate over the next year or so, as companies use low-cost debt to pursue merger and acquisition deals, and banks offer easier financing for private equity transactions.

With credit spreads – the yield differences between bonds carrying default risk and comparable US treasury securities – historically tight across nearly every US credit sector, investors may need to cast a wider net in 2022. EM corporate debt is the one global credit sector that still appears extremely cheap, especially in Asian markets. However, a positive outcome for Asian credit in 2022 will require a successful stabilisation of China’s economy.

Capex revival on global green revolution

By Justin Thomson, CIO and Head of International Equity, and Mark Vasekiv, CIO Fixed Income

“The push for sustainability could generate a more extended wave of investment in physical infrastructure...”

ACTIONABLE INVESTMENT SNAPSHOT

On the global sustainability path, cyclically sensitive asset classes will be in focus, with infrastructure needs and the shift to renewable energy set to boost capital expenditures. The producers of capital goods and key raw materials are likely beneficiaries – as are banks and high yield investors, which finance green projects.

Vulnerable supply chains, crumbling infrastructure, higher energy prices, and a longer-term need to reduce carbon emissions have all helped push economic sustainability to the forefront of the global policy agenda. This could boost public and private fixed investment in 2022, supporting economic growth.

Global corporations appear to have ample resources to finance fixed investment, thanks to strong earnings, spending restraint amid the pandemic, and a surge in low-cost borrowing. The cash holdings of the companies in the S&P 500, for example, totalled nearly US\$2trn at the end of September 2021.

Corporate spending on fixed investment has been relatively restrained for the past several decades, in part because new technologies enabled companies to boost productivity and profitability without heavy capital outlays. But that may be changing. Economic recovery spurred a sharp cyclical acceleration in capex in 2021. The push for sustainability could generate a more extended wave of investment in physical infrastructure – such as ports, highways and power grids – and in capital goods manufacturing.

Multiple drivers of increased expenditure

We have identified several trends with the potential to drive capex. For example, meeting the international target of ‘net zero’ carbon emissions by 2050 will require heavy investments in utilities, the automotive sector, and green technologies. Ports and maritime fleets also need to be expanded to bolster global supply chains – while onshoring those supply chains could boost demand for warehouses, rail and truck delivery, and domestic factories.

In addition, upward pressure on wages could produce a substitution effect, as companies try to replace labour with capital, spurring investment in factory robots and other automation equipment. Companies may also decide to rebuild depleted inventories, which in turn could spur investment in new productive capacity.

Finally, fiscal policymakers appear more relaxed about spending, debt, and inflation. This could clear the way for public infrastructure spending – as evidenced by the US\$1trn package passed by the US Congress in late 2021. For investors, these trends could generate potential opportunities in both equity and credit markets in 2022.

An exciting decade-long transformation

A capex boom could be expected to boost sales and earnings for capital goods manufacturers, to the potential advantage of stock markets in Germany and Japan, which host some of the world’s leading industrial companies. European banks, which have carved out a major role in financing investments in solar, wind, and other renewable energy sources, could also be indirect beneficiaries.

Financing ‘transformational’ industries has long been a core competency for high yield debt markets, as evidenced by the role high yield financing played in getting the electric vehicle industry off the ground. While this could be an exciting decade as we move from traditional carbon fuels to cleaner sources of energy, demand could also be high for ‘transitional’ fuels – particularly natural gas. This likely would require substantial investment in gas production and distribution – with global high yield markets well positioned to provide this capital.

The run-up in energy prices seen in 2021 could also help reduce carbon emissions, by restraining demand for oil and making renewable sources more competitive. To a considerable extent, higher energy prices are the product of a steady decline in oil and gas investment – partly driven by pressure from activist shareholders but also reflecting the industry’s poor profitability. In fact, some of these companies have not generated free cash flow for years, with some major oil stocks significantly below levels seen five years ago – in the middle of one of the greatest bull markets in history.

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