In With a Whimper, Out With a Bang

The investment story of 2022 will be tactical bear, structural bull.

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This year will start with a whimper as headwinds, the coronavirus omicron variant included, weigh on growth. As the months pass by, these headwinds will likely abate, and I expect 2022 to end with a bang. From an investment perspective, I would characterize the year as tactical bear, structural bull.

Let's start with the structural story: Why do I hold a bullish view? When I observe the global economy, I see a large amount of pent-up demand, especially outside the U.S., and output gaps that are still open. Financial conditions remain very accommodative, and, following a decade of deleveraging and recent fiscal largesse, private sector balance sheets are strong. The fly in the ointment is inflation, which has surged much above most peoples' expectations—and even above the expectations of those who say they always knew inflation was just around the corner. Consequently, this is an economy where, virus outbreak permitting, private demand can accelerate substantially.

The pickup in private demand will likely be supported by easy financial conditions and strong private sector balance sheets. The still-open output gaps ensure that, although monetary accommodation is being removed, there is no need for policymakers to shift to a pace of tightening that threatens the business cycle expansion. However, as the year progresses and residual output gaps close, monetary policymakers will likely become increasingly assertive in their quest to tighten monetary policy.

So far, so good. But what about inflation? When I trawl through the details of inflation reports, I find many clues that point to the much-debated supply chain issues. In the U.S., for example, auto sales have plunged to an extent that could easily lead you to believe that the U.S. is in a recession—yet the price of used cars has soared by just under 50% over the past 18 months. These figures tell me that today's inflation has not been caused by economic overheating, but rather by supply-side constraints, and as supply chain issues are gradually resolved, the bulk of the inflation pressures we experience today will recede.

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Finally, China. The leadership of the world's second-largest economy took advantage of the 2021 global growth rebound to launch a sequence of reforms and initiate a campaign to reduce the overall leverage of the economy. I have long looked at the growth slowdown in China with some unease, but the leadership has sent a clear message that it will put a greater emphasis on growth. I am not looking for a massive growth rebound—but a stabilization and some recovery in a growth trajectory that has, over the past 12 months, been continuously sliding will be welcome news.

Against this very positive structural story, I retain a near-term bearish bias. The unfolding of the omicron variant is set to aggravate a growth slowdown that, in my view, was already building. This slowdown is driven by a combination of three things: first, rising inflation, in particular energy prices, which limit households' purchasing power; second, supply chain issues, which have slowed the pace of capital accumulation; and third, fiscal headwinds, concentrated in particular in the U.S. In addition, the U.S. Federal Reserve—the central bank at the center of the financial system—has turned more hawkish. Although the signals of growth stabilization from the leadership of the world's second-largest economy, China, are encouraging, for now, the data flow remains soft.

Clarity Over Omicron Measures Will Refocus Markets' Attention

Will financial markets look through the initial softness and focus on the more constructive story or will it retain a more myopic point of view and focus on the near-term challenges? I expect that growth-sensitive assets, like equities, may exhibit some volatility as the market continues to digest the full implications of the omicron variant and the slightly faster pace of monetary tightening from the Federal Reserve.

As there is more clarity about the management of the omicron variant and supply chain issues begin to ease, I expect the market to shift focus to the structural story—and this story is very positive for equities. However, the market can only take the long view when uncertainty around the path to that long view fades—in other words, when we understand what restrictions U.S. and European policymakers are likely to impose to keep the outbreak at a politically manageable level.

Subject to the same caveats about the ability of markets to shift focus to the structural story, I expect that bond yields will end 2022 substantially above the current levels. Although the resolution of supply chain disruptions will likely lead to lower inflation, it is also likely to push bond yields higher as central bankers become increasingly comfortable about removing monetary stimulus. The market will likely sniff that out some time in advance.

When it comes to regional focus, I see a greater pent-up demand, and a larger output gap, outside the U.S. Once the near-term uncertainty resolves, the non-U.S. part of the world, in particular Europe, will present the more interesting investment opportunities.

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