

Economic and market outlook 2022



The COVID-19 crisis dug a deep economic hole in 2020. In 2021, that hole was filled in. In practice, the recovery has not been as straightforward as that metaphor might suggest. The reimposition of restrictions across many large economies weighed on global growth during the first quarter of the year. While some restrictions remained in place, countries began to vaccinate their populations, leading to a step-by-step return to normality. The economic reopening unleashed huge pent-up demand, leading to a strong pickup in economic activity. Although some of that economic momentum was lost going into the end of the year on the back of supply-chain disruptions, uncertainty around new variants, high energy prices, and weaker growth in China, we believe 2022 should see the economic recovery continue.

Back to the metaphor: If 2021 was the year when the hole was filled, 2022 should see building work commence on the freshly leveled ground. In economic terms, we expect the global economy to recover to where it would have been had the virus never hit, and in some cases, to grow even beyond that. Strong income growth, coupled with healthy consumer balance sheets, should support consumption.

We are also seeing encouraging signs on the investment front, with businesses engaging in capital-intensive projects. Governments are not planning to tighten their belts as aggressively as they did in the wake of the global financial crisis, with government spending and investment set to remain elevated. All of that creates a positive macroeconomic backdrop for the year ahead.

Inflation has picked up sharply, driven by significant base effects, reopening price pressures, disrupted global supply chains and much higher commodity prices. Although some of these effects are temporary in nature and should fade over

the medium term, inflation should continue to be supported by wage growth and generally higher inflation expectations.

The year ahead is interesting from an inflation dynamic perspective. Although we believe the underlying pressures will persist, headline year-on-year inflation rates should fall because of base effects.¹ On a longer-term average basis (which ignores base effects), inflation is likely to be higher than it has been for some time, especially in the US, Canada and the UK, while moving up toward target in the eurozone and rising slightly in Japan.

In 2020, monetary and fiscal policy worked in tandem to help the global economy withstand strict lockdown measures. 2021 saw a broad continuation of that, with governments willing to spend and central banks remaining broadly accommodative. As the year-end approached, a few central banks started to withdraw their support measures as their policy objectives were increasingly met. The Bank of Canada announced in October that it is maintaining rates at its current low levels, but is ending quantitative easing (QE) and moving into the reinvestment phase, during which it will purchase Government of Canada bonds solely to replace maturing bonds. The Bank of England was particularly hawkish, while the US Federal Reserve (the Fed) remained quite balanced (trimming its asset purchase program while delaying rate hikes). The European Central Bank and the Bank of Japan retained their broad support measures. 2022 should be a year when more of the emergency monetary policy measures of 2020 are unwound, while fiscal policy remains supportive (although compared to 2021, it will be tighter). If communicated well, it should not upset risk markets too much, and if done gradually, it should not upset the broad economic outlook either.

Equity markets have had a very strong 2021, as the economic reopening supported earnings growth and discount rates remained low, especially in real terms.² The positive headline performance masks the evolving themes of the year, with numerous rotations taking place between equity factors. Although the fundamental backdrop is supportive for earnings, stretched valuations and some clear signals of market froth make our overall view on equity markets more neutral. We do see value opportunities within equities, for example, in emerging markets.

Nominal bonds have had a volatile year, selling off sharply

¹ The low price level in 2020 means that when prices normalize in 2021, they rise by a lot on a year-on-year basis. That is a base effect increasing inflation. High prices in 2021 mean inflation is likely to fall in 2022 because of base effects working the other way.

² Inflation adjusted.

at the start of 2021 as inflation and growth picked up. The mid-year saw bond prices rally on the back of supportive technical factors and growth concerns, amid intensifying supply chain pressure and some concerns about the potential demand impact of another coronavirus variant. The theme of inflation took centre stage going into the end of the year, leading to yet another selloff in nominal bonds. On a real-yield basis, bonds have not sold off much, in fact they rallied in some countries. We expect bond yields to edge higher (or prices to move lower) as economies recover and inflationary pressures persist.

Credit markets have had a reasonably dull year, with spreads³ tightening modestly. The biggest driver of return over the year was duration. Investment-grade corporate bonds, with their higher durations, underperformed sub-investment-grade corporate bonds, which have much lower duration and higher yield. Our outlook on duration is broadly negative, while our outlook on credit spreads is relatively benign. Although spreads are already at low levels, we believe they should stay tight, as economic recovery, coupled with healthy corporate balance sheets, should lead to limited default/downgrade activity, offering credit investors a reasonable carry return.

Both hard- and local-currency emerging markets debt struggled in 2021. The former was dragged down by a selloff in developed markets duration, while the latter struggled because of the appreciating US dollar and rising inflation in much of the world. The outlook for local-currency emerging markets debt is broadly positive, as local currencies are cheap versus the US dollar. The outlook for hard-currency debt is positive on the spread, but negative on the overall return profile because of its exposure to developed markets duration.

The US dollar has had a strong year because of strong US growth and higher US bond yields. Its major counterparts, the euro and the Japanese yen, struggled. The Canadian dollar however ended the year close to where it had begun against the US dollar. Emerging market currencies sold off over the year on the back of less favourable COVID-19 dynamics on the back of slower uptake of vaccinations. 2021 saw a sharp rally in commodity prices as booming global demand overwhelmed available supply. The year also saw substantial rallies in alternative assets, such as

cryptocurrency. We expect the US dollar to depreciate modestly, against both developed market currencies and emerging market currencies.

One of the key risks to financial markets is a policy mistake by a central bank. For example, take a situation where higher inflation persists and the Fed does not increase interest rates. That could lead to inflation expectations becoming unanchored, which would then force the Fed to aggressively tighten policy and likely cause a recession.

We believe the Fed is running that risk now, as inflation (and average inflation) is clearly elevated, growth is robust, yet the Federal Open Market Committee is communicating only a gradual path of monetary policy normalization.

Another key risk is the emergence of another variant of the coronavirus, overcoming the defense offered by currently available vaccines. In this scenario, countries may have to reimpose lockdown measures until vaccines are updated.

The longer current supply chain disruptions persist, the bigger the risk they pose to the broader economic outlook. What do we mean by “disrupted supply chains”? Some countries are still constrained in their production, affecting just-in-time manufacturing. The cost of shipping has skyrocketed to multiples higher than normal levels. Booming consumer demand has led to very low business inventory levels. In short, people want goods, but there are not enough to go around, and moving them is proving especially troublesome. That weighs on growth and creates inflationary pressures. Although we expect these distortions to be temporary in nature, they seem to be dragging on for longer than the market expected.

The US–China geopolitical tensions persist and we believe continue to pose a risk to financial markets. Although we do not expect a Trump-like trade war between the world’s two largest economies, we expect frictions along technology and regional military influence fronts to persist. Taiwan–China relations are particularly tense, which could lead to bouts of market volatility. Generally, we do not expect geopolitical developments to have any long-lasting effects on financial markets, but we are aware that lots of geopolitical factors are largely unforecastable. There are also risks emanating from inside China, in terms of further regulatory crackdowns.

³ The difference in yields between a corporate bond and a duration-matched government bond.

What happened in 2021?

The global economy continued to recover from what was one of the sharpest and deepest recessions in history. Although COVID-19 remained a factor, its impact was less than that felt in 2020. This is because lockdown measures were not as indiscriminate in large, developed economies, with restrictions mostly focused on the services sector. Furthermore, many countries rolled out their vaccination programs, which slowly but firmly reduced hospitalizations, serious illness and death.

Not all countries had equal access to vaccines, and not all countries moved at an equal pace (see Figure 1). That led to divergent global recoveries. The US, Canada, Europe and other regions with highly vaccinated populations reopened, which has led to a sharp pickup in economic activity. Much of Asia-Pacific and a number of emerging market countries where populations were not as well vaccinated early on in 2021, had to reimpose restrictions, therefore lagging behind.

Central banks continued their support measures, underpinning very easy financial conditions. In other words, it was easy to borrow, and banks and bond markets were eager to lend, which aided both business and consumer sentiment. Governments remained supportive

too, extending numerous crisis response measures, such as income support in the US and Canada and furlough measures in the UK, before paring them back in September as labor markets recovered.

The reopening (albeit not uniform globally), coupled with supportive policy measures, helped the global economy grow strongly during the second and third quarters, continuing down the path toward full recovery.⁴ Economic momentum slowed somewhat into the fourth quarter, as central banks engaged in less supportive rhetoric, energy prices spiked, supply chains got stretched and China slowed amid its regulatory crackdown. The effects of a new wave of infections caused by the Omicron variant of the SARS-CoV-2 virus first detected in South Africa were also beginning to cause worry as we entered the last weeks of the year.

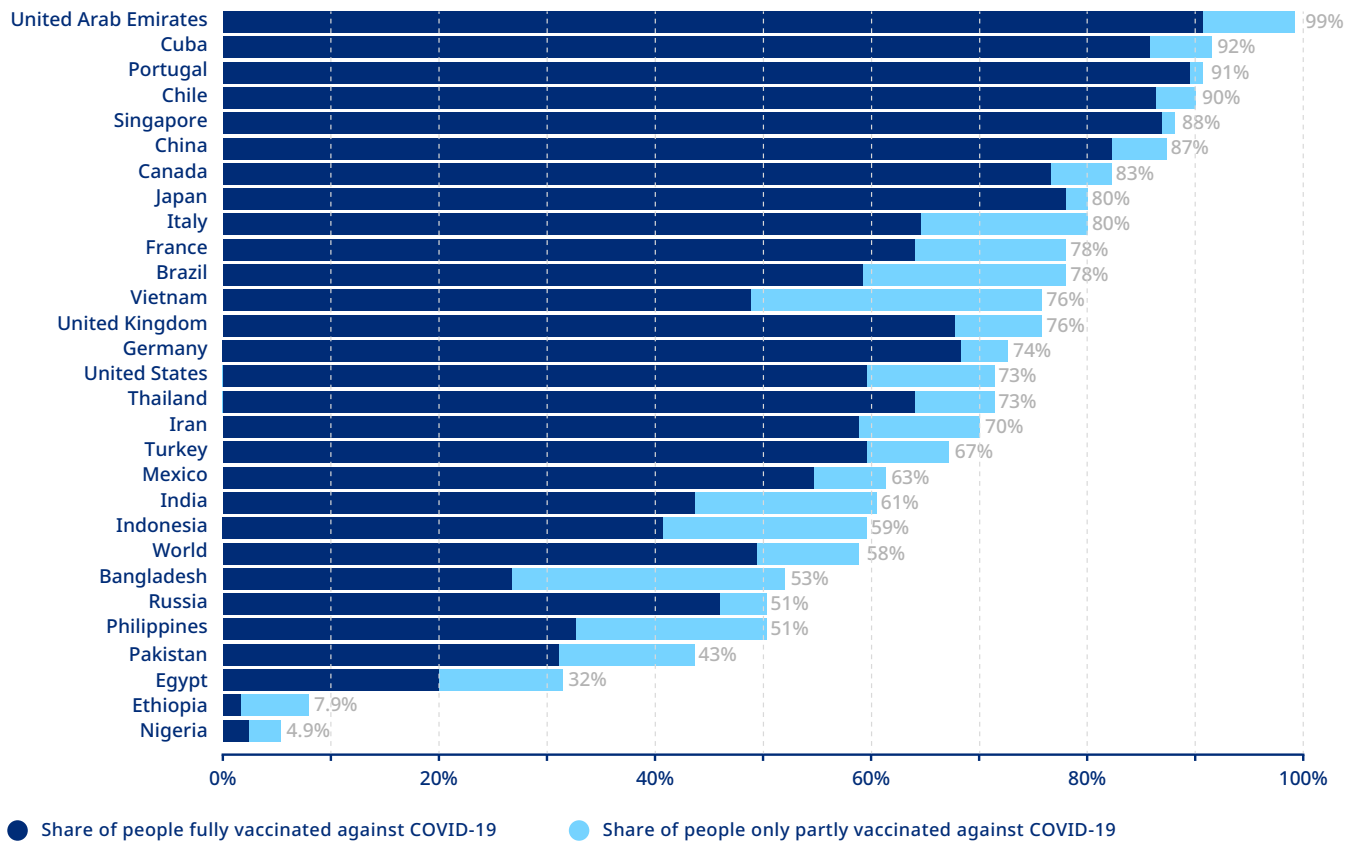
One of the biggest topics, and arguably one of the key market drivers of the year, was inflation. It picked up sharply in a number of economies (especially in the US) because of base effects,⁵ high consumer demand, higher commodity prices and disrupted supply chains adding to the pressure on goods prices.



⁴ Full recovery is getting back to where an economy would have been had the virus never hit.

⁵ Prices were very low a year ago because of the crisis; returning to more normal prices now leads to a large rise in year-on-year inflation.

Figure 1 - Share of population vaccinated against COVID-19



Source: Official data collated by Our World in Data

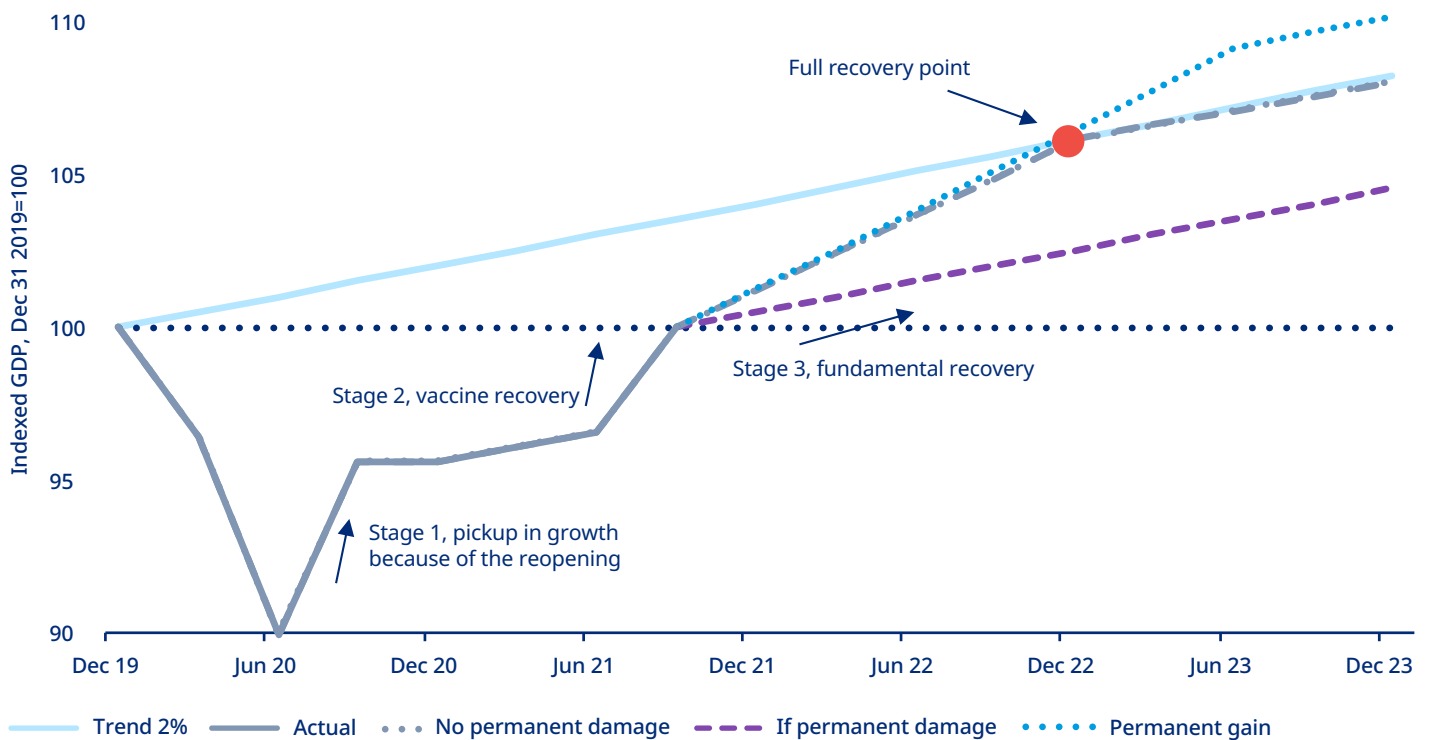
Note: Alternative definitions of a full vaccinated, e.g. having been infected with SARS-CoV-2 and having 1 dose of a 2-dose protocol, are ignored to maximize comparability between countries.

What do we think will happen in 2022?

We are broadly positive on the economic outlook. Strong income growth coupled with healthy consumer balance sheets should support consumption. We are also seeing encouraging signs on the investment front, with businesses engaging in capital-intensive projects. Governments, unlike after the global financial crisis, are not planning to tighten their belts anytime soon, with government spending and investment set to remain elevated. Against this backdrop,

we believe that the global economy is well on track to recover to where it would have been had the virus never hit and perhaps even to exceed that level. Virus-related restrictions and energy price spikes might weaken growth for a couple of quarters, but we expect growth to recover after things normalize, returning economies to their original trajectories toward full recovery (see a model example in Figure 2).

Figure 2. Recovery model example for developed economies



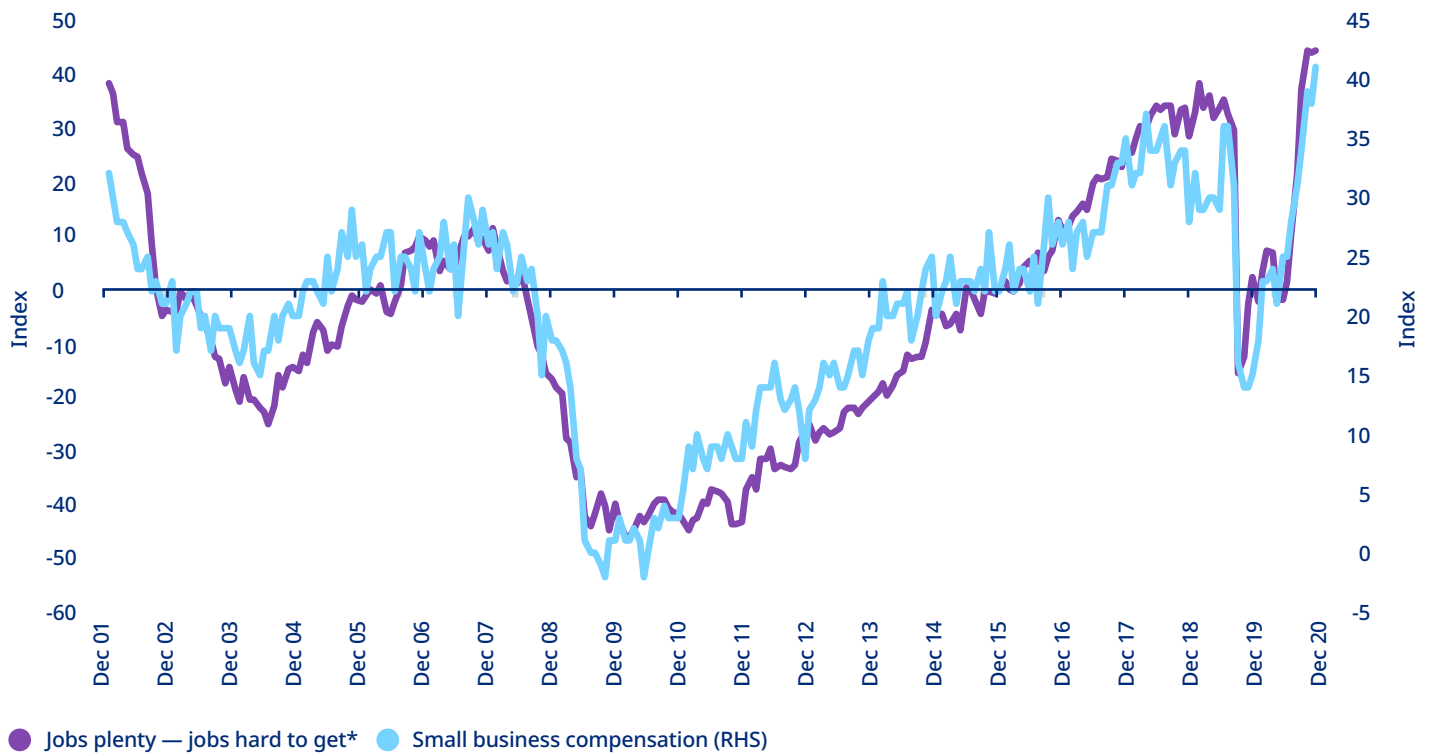
Source: Mercer, illustrative purposes only.

The trend light blue line illustrates where the economy would have been had the virus never hit. The grey line shows the actual path of GDP. The grey dotted line shows a scenario where the economy recovers without permanent scarring. The purple dotted line shows a scenario with permanent scarring. The blue dotted line shows a scenario where the economy is fully above where it would have been had the virus never hit.

On the subject of inflation, this is partly caused by transitory factors; however, some of it is not, and by the time these factors fade, there may be other inflationary forces to deal with, principally, wage growth driven by tight labor markets. We are seeing plenty of signs that companies are struggling to hire and are raising or planning to raise compensation (see Figure 3, which illustrates how a tight labor market leads to wage pressures in the US). Higher wages mean businesses need to increase their prices to protect their

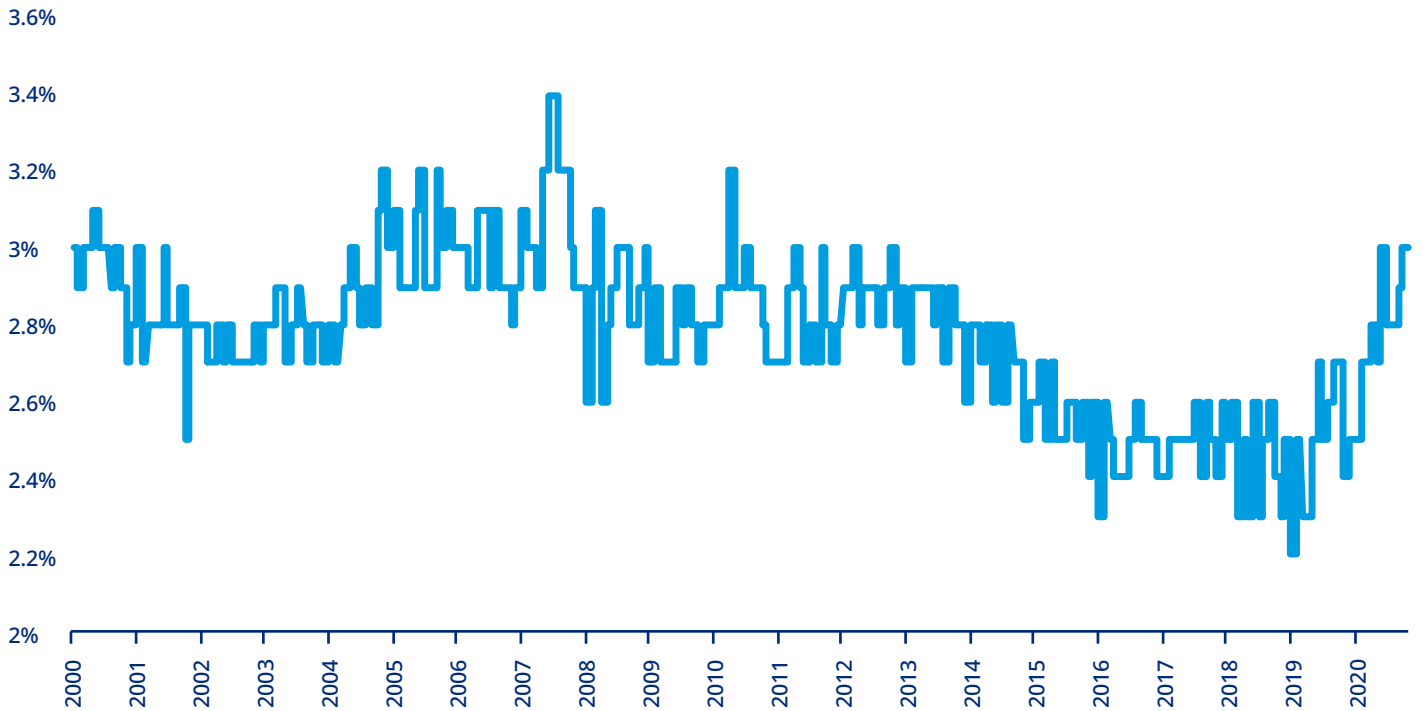
margins, which leads to consumers demanding higher pay in their jobs, creating a self-enforcing cycle of underlying price pressures. While we expect this environment to persist, we do not expect inflation to get out of control like it did in the 1980s (see Figure 3.1 for inflation expectations which are higher but broadly contained for now). Current inflation dynamics have important policy implications, which we will discuss in a separate section.

Figure 3. US labor market



Source: Bloomberg as of October 26, 2021.

* a random household is asked two questions: do you see plenty of jobs available? Do you find it difficult to find a job? The answers are aggregated and respective index series are produced. We take the difference between the two series to understand how well or how badly the labour market is doing.

Figure 3.1. US headline inflation expectations, 5-year

Source: Bloomberg as of October 26, 2021.

Sustainability is at the forefront of institutional decision-making.

Investors increasingly incorporate ESG principles in their stock/fund selection process and they are making long term commitments to decarbonize their portfolios. Financial markets continue to evolve, together with numerous sustainability-aware investments gaining popularity both in private and public space. For example, the UK government has recently issued 'green gilts'. Although we expect this trend to continue and drive important conversations and decisions over the medium term, the impact of sustainability over 2022 is likely to be fairly limited on overall market direction, but will continue to impact investor preference and single stock/bond movements.

Regional outlooks

Canada

The Canadian economy recovered nicely in 2021, though an uneven growth trajectory led to a slowdown in GDP projections in the second half of the year. Growth projections however remained strong for 2022 with the IMF estimating growth for Canada at 4.9%⁶ within its latest published outlook. The Bank of Canada however forecasted a slightly lower rate of growth of around 4.3%⁷ for Canada at around the same time.

Supply chain bottlenecks, pressure from labour shortages, and broader pandemic-related disruptions have not spared Canada. Concerns around how persistent the recent bout of higher inflation will be, and what the potential path to a normalizing interest rate environment will look like, will continue to prevail in 2022.

The 2021 Federal election however, left the balance of power in Ottawa largely unchanged, signaling no major changes in the direction of government policy going into the next year.

Higher rates of vaccination in Canada, which ranks amongst the highest in the world, should provide some support for a continued recovery, though the threats of new lockdowns on difficult-to-distance sectors of activity caused by potential new variants of the SARS-CoV-2 virus (Omicron being the latest) will continue to weigh.

United States

The US economy cruised through 2021. Unlike its developed counterparts, the US did not impose major restrictive measures at a federal level, but certainly did at a state and local level. Instead, the federal government focused on rolling out the vaccination program as soon as possible.

A more regionalized and pragmatic approach to restrictions, coupled with supportive fiscal stimulus measures and accommodative central bank measures underpinned strong economic activity in 2021. Going forward, following a modest softening in data toward the year-end, we think the US economy is well on track to recover to where it would have been had the virus never hit and perhaps beyond. Consumption should be well supported by income growth (plenty of jobs, rising wages) and positive balance-sheet effects (high savings, which should support spending). Investment is booming, with businesses, encouraged by easy financial conditions, committing to capital-intensive projects. This creates a positive macroeconomic backdrop, even as elevated government spending this year weighs on next year's growth data.⁸

Inflation in the US is a highly pertinent issue. It has risen sharply and is forecast to finish the year at 5.6%⁹ while the measure that excludes the volatile items of food and energy is at 4.5%¹⁰. Clearly, inflation is above the rate targeted by the Fed and it is not necessarily all transitory. In fact, price pressures have broadened recently, with the shelter component of the inflation basket also on the rise. Input cost inflation is showing few signs of subsiding too, with energy prices elevated and wages on the rise. Companies are struggling to hire, people are quitting their jobs at a record pace, and both employees and prospective employees are all demanding higher pay (**see Figure 4 for wage trackers**). Importantly, companies have shown both a willingness and an ability to pass on these input cost pressures to the end consumer. We expect this theme to continue, underpinning the broader inflation rate (even though we expect it to fall in 2022 because of base effects) and prompting monetary policy changes.

⁶ Source: IMF World Economic Outlook (WEO) - October 2021

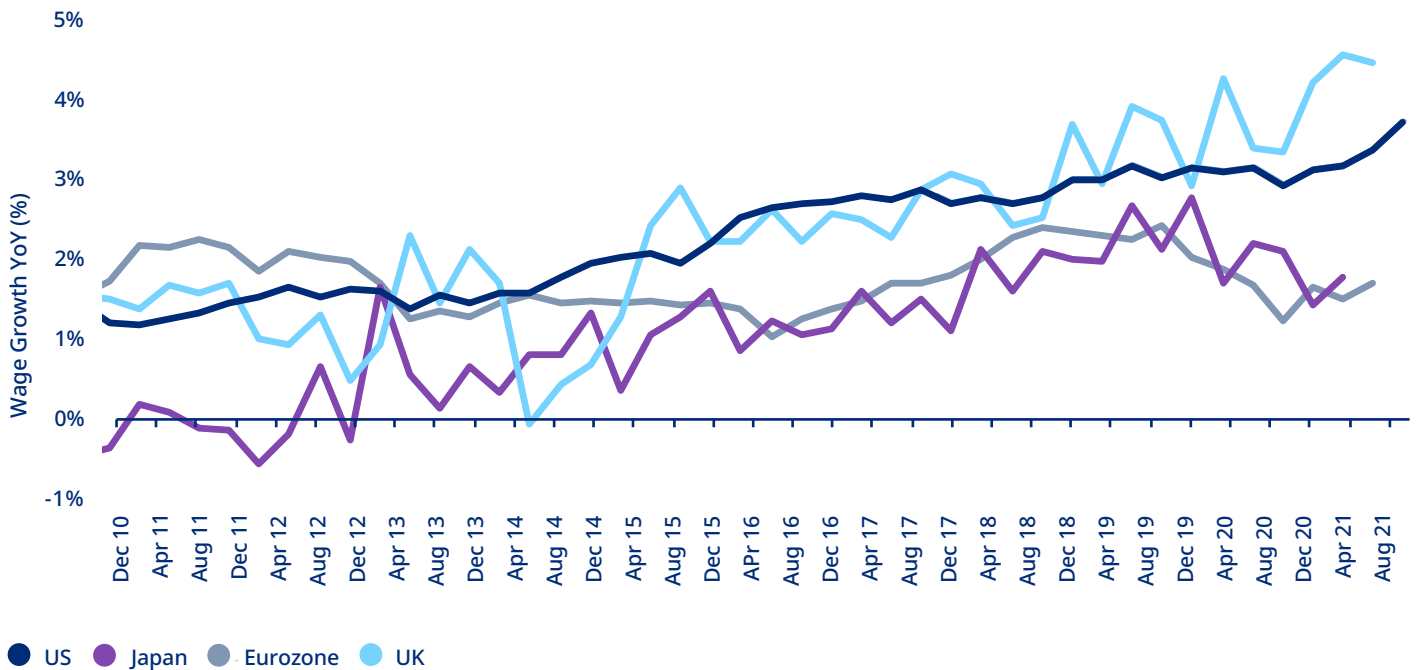
⁷ Source : Bank of Canada Monetary Policy Report – October 2021

⁸ Positive impact on growth now because of elevated government spending means a negative impulse on growth tomorrow. This is called a negative fiscal impulse.

⁹ Broad CPI year-on-year measure. Source: Goldman Sachs, October.

¹⁰ Source: Goldman Sachs, October.

Figure 4. Wage tracker



Source: Goldman Sachs as of October 26, 2021.

Eurozone

In comparison, the eurozone did not do as well in 2021 as the US, mostly because it was a bit slower to roll out its vaccination program. The ensuing restrictions were not as severe as those imposed a year ago, but they weighed on growth nevertheless. As the pace of vaccinations picked up and restrictions were gradually lifted, economies rebounded over the European summer, with some moderation into year end.

One of the few silver linings of the COVID-19 pandemic was the establishment of the European Recovery Fund. This is the first time the EU has engaged in a fiscal transfer exercise that is funded by commonly issued debt, aiding countries most in need (e.g., Italy). Although it is unlikely to be a permanent tool like the regular interstate fiscal transfers in the US, it does establish an important precedent for future crises, taking some weight off the shoulders of the European Central Bank.

2021 marked the end of an era in German politics, with Chancellor Angela Merkel departing the political stage after more than 20 years of leadership. We believe that the coalition between the SPD, Greens and Free Democrats (leaving the incumbent Merkel's party out of power) will be more fiscally expansive, creating a positive macroeconomic backdrop for the whole region. However, we do not expect it to be a major game-changer, because of the difficulty in getting policy measures passed through both chambers of the German Parliament.¹¹

A strong 2021 should be followed by a strong 2022, as European economies get back to normal and the policy mix remains accommodative. In terms of growth, in 2022, we do not expect the economy to get back to where it would have been had the virus never hit, but we think it will continue to make up lost ground.

¹¹ For example, in order to get rid of the so-called "debt brake," you would need a two-thirds majority in both chambers of the German parliament. Difficult to achieve with a thin ruling coalition.

United Kingdom

The UK, similar to its developed counterparts in Europe, locked down again early in the year and reopened in the spring. Its GDP dynamics reflect that, with growth shrinking by in Q1 and bouncing back in Q2 and in Q3. It also emphasizes a very important point: Lockdowns largely delay growth, they do not eliminate it, especially if fiscal policy is able to loosen in response to any restrictive measures. The last quarter of 2021, although positive, was a bit softer because of the energy crisis, supply-chain disruptions, labor shortages and the China slowdown weighing on macro-sentiment. Going forward, the UK is in decent shape to continue its path toward full recovery.

One big uncertainty for the UK is the extent of the ongoing disruption caused by Brexit, as businesses readjust to the new reality and new terms of trade. Because the exit from the European Union and the arrival of COVID-19 overlapped, it is very difficult to disentangle the two and determine the impact that the new trading relationship has had on the UK economy. Ongoing squabbles with the EU over Northern Ireland and shipping rights are another source of uncertainty and pose short-term risks to trade.

Japan

Japan's COVID-19 policy differed from that adopted by Canada, the US, UK, and Europe. There were no restrictions on movement, while bars and restaurants were encouraged, but not forced, to close early. Nevertheless, people adjusted their behavior regularly, based on perceived virus trends. Fiscal transfers were also relatively limited, while monetary policy was not eased further during the recession. The economy shrank in Q1 and rebounded modestly in Q2, before shrinking again in Q3. The end of the year is looking stronger because of the recent reopening.

We expect a strong start to the year, as high vaccination rates will finally allow Japan to experience its first post-COVID boom in consumption. Numbers should soften after that but continue to be supported by strong capex and a strong labor market. Japan is the only major economy expected to grow more strongly in 2022 than 2021. Nevertheless, Japan may struggle to get back to where it would have been had the virus never hit.

Similar to Europe, Japanese inflation has risen from low levels because of global pressures, but domestic price pressures remain muted. The headline inflation rose slightly and is forecast to finish the year at 0.7%,¹² core at 0.7%¹³ which is well below the central bank target. We struggle to see the dynamic changing and believe inflation will remain muted for a while to come, 2022 at the very least.

Emerging economies

China is the first country to recover to where it would have been had the virus never hit. Like much of the APAC region, Chinese authorities opted for a zero-COVID-19 tolerance-policy. That meant any outbreak was met with very strict regional lockdown measures — a dynamic enforced in 2021 and weighing on growth numbers. Economic activity was further dampened by a regulatory crackdown, with Chinese authorities targeting certain sectors of the economy (technology, property, education) under the banner of “common prosperity.”

We do not expect the current soft patch of growth to persist long into 2022, and we anticipate the economy to recover as policy measures turn a bit more stimulative. The US–China frictions persist on numerous fronts, and we expect economic and political decoupling to continue. Regulatory risks remain ahead of the politically important National Congress of the Chinese Communist Party in late 2022. While these actions may have negative consequences for certain sectors of the economy, we do not believe this signals a shift in the strategic objectives of Chinese policymakers, nor a deprioritization of economic development. Rather, the actions seek to strengthen the economy by preventing concentration of market power, and encouraging capital and labor to be allocated toward productivity-enhancing uses, with the ultimate aim of enabling China to become an advanced economy. While these steps may be positive over the long term, they are not without risk in the short term.

In a similar vein, the crackdown on the property sector can be viewed as an attempt to reduce vulnerabilities within the economy. Housing affordability is very low in tier-1 cities. Meanwhile, strict rules to cap property developers' borrowing — “the three red lines” — were introduced in late 2020, prompting them to deleverage, pushing some

^{12, 13} Year-on-year inflation measure, forecast for the 4th quarter. Source: Goldman Sachs.

developers into stress and leading to an economy-wide slowdown in housing starts and residential sales growth. Given property is directly and indirectly estimated to contribute approximately 30% of China's GDP growth, these efforts will weigh on growth in the near term. However, policymakers are keen to prevent this getting out of hand, and in late 2021 have been encouraging banks to loosen household lending standards, while retaining tight conditions for developers. It appears that policymakers may be attempting to engineer a transfer of liabilities from highly leveraged property developers to households, while at the same time, preventing froth from emerging in the housing market. With multiple, potentially competing,

objectives in the housing sector, the risk of a policy error is real. However, we expect any problems to be contained, given that banks are well capitalized, and housing inventories and leverage are modest.

Growth in the emerging world ex-China is buffeted by the same factors as most other countries; lockdowns mean a bad quarter, reopening means a good quarter. Compared to developed markets, however, the vaccination campaign has not been as aggressive and more restrictions were imposed. Our outlook on emerging economies ex-China is constructive, assuming vaccination programs gain critical mass; however, we do acknowledge the headwinds coming from the monetary policy of tighter developed markets.



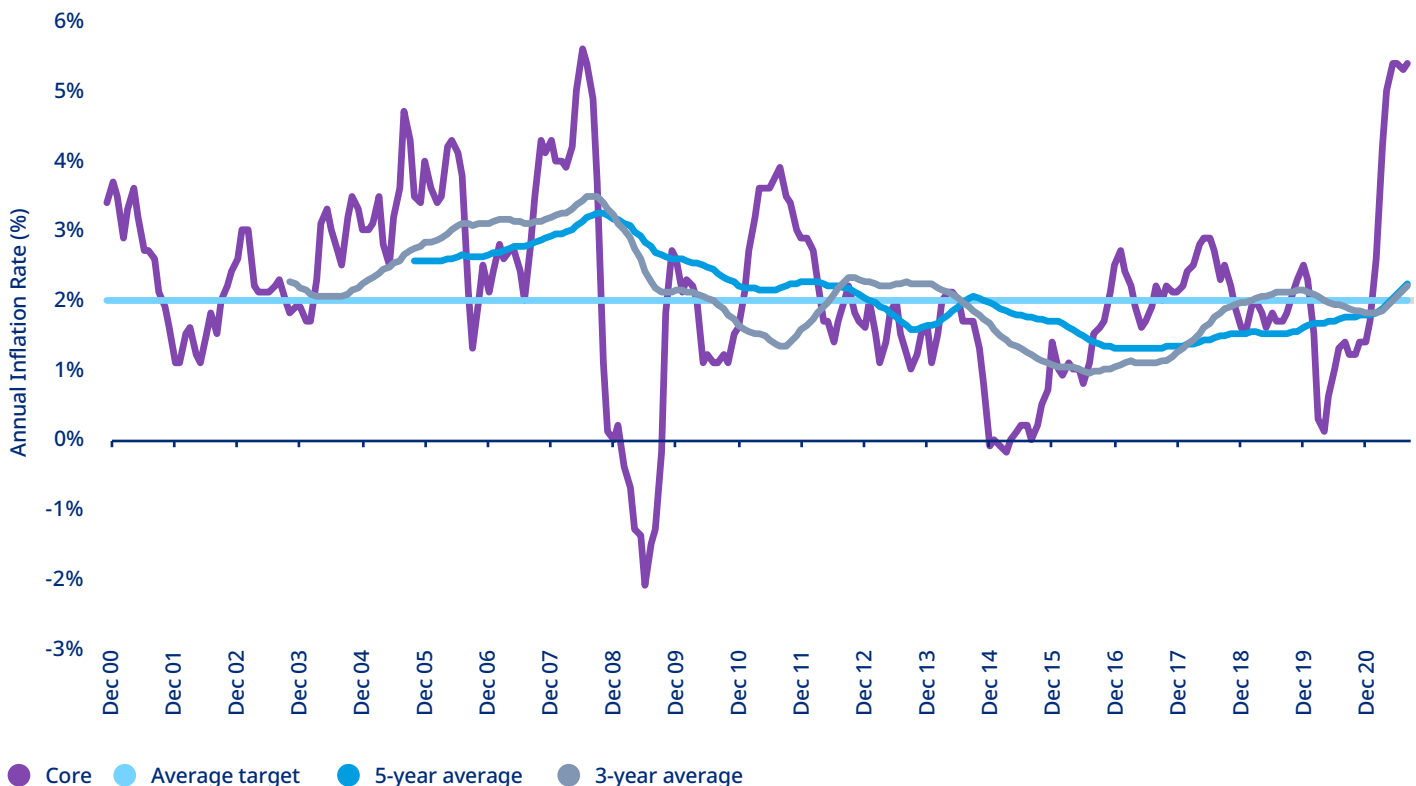
Central bank outlook

Faced with a crisis of unprecedented scale in 2020, central banks reacted aggressively, slashing interest rates to historically low levels, announcing numerous credit-easing policies and increasing the size of quantitative easing measures. The ultra-loose monetary policy did its job by creating very easy financial conditions which have been instrumental for the economic recovery. While that persisted for most of 2021, the conversation shifted from “ultra-easy” towards “planning for tightening” in the first half of the year and “actually tightening” towards the end of the year.

Of course, not all regions are in the same situation and not all central banks have equal mandates. From a Canadian perspective, the Government of Canada and the Bank of Canada renewed in December the overall policy framework first adopted 30 years ago and will continue to focus on maintaining low, stable inflation over time - as measured by the 12-month rate of change in the consumer price index - at 2%, with an inflation-control range of 1% to 3%. This is referred to as flexible inflation targeting.

It is however difficult to imagine a situation where Canadian monetary policy becomes substantially decoupled from policy south of the border. The US Federal Reserve has a dual mandate. It works to ensure price stability, which, as per the latest monetary policy review, is defined as average inflation targeting. That means when inflation runs below 2% for a few years, the Fed will tolerate an overshoot for the next few years. The Fed also aims to achieve full employment. On the price stability front, whichever way you slice it, the Fed has achieved it (**see Figure 5 that demonstrates how current core inflation is above target on three- and five-year averages**). On the full-employment front, although the unemployment rate is still above where it was pre-crisis, there is plenty of evidence that the labor market is tight, creating significant wage pressures. Against this backdrop, we believe the Fed will tighten its monetary policy by tapering asset purchases and raising the policy rate in 2022. We believe the tightening cycle will be slightly more aggressive than is currently priced in by the market.

Figure 5. US core inflation % (CPI)



Source: Goldman Sachs as of October 26, 2021.

Global Asset Class Outlook

Equities

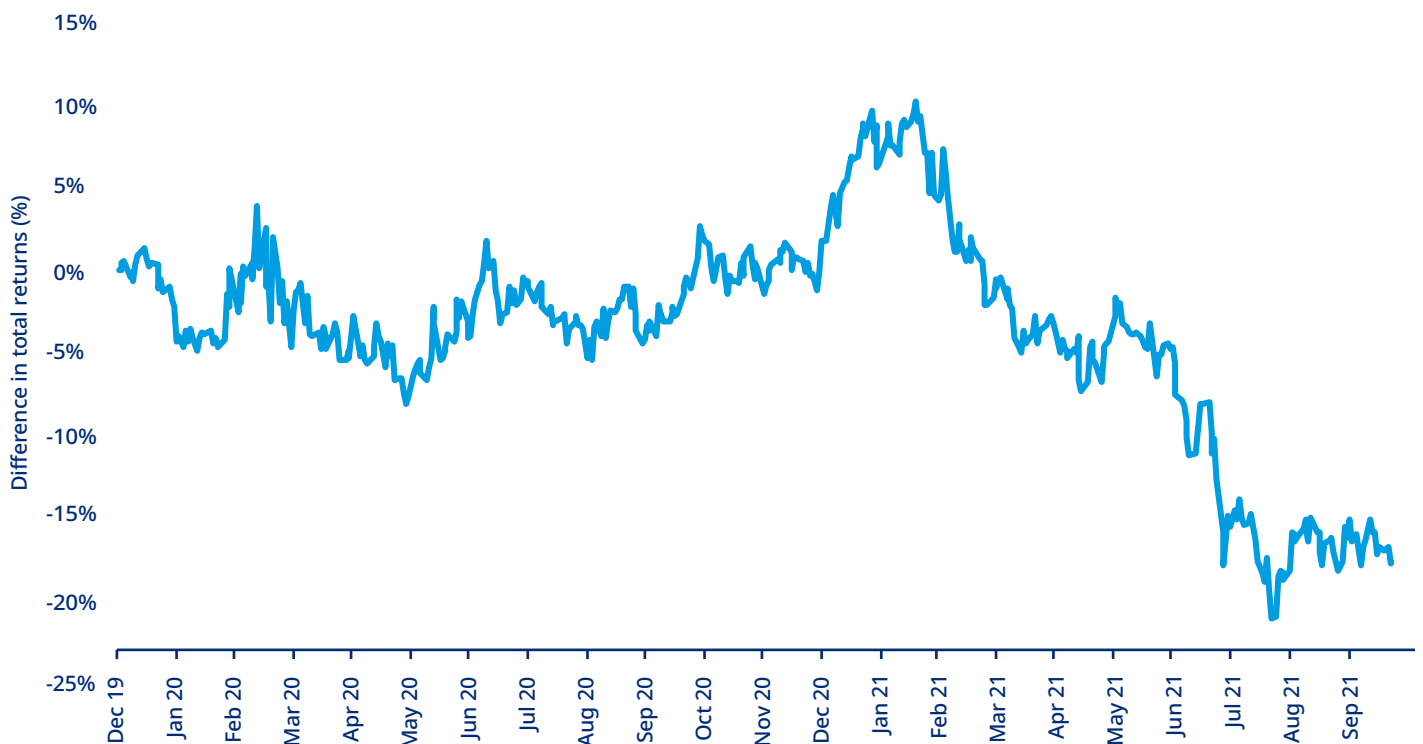
2021 has been a great year for developed market equities, which rallied by approximately 19%¹⁴ year-to-date. However, it has in no way been a quiet year, with numerous stories playing out within the asset class. The first few months of the year could be classified as “reflation”; that is, an environment of high growth and accelerating inflation, an environment where low-duration assets perform better than high-duration assets. In equities, that meant companies whose cash flows are sooner rather than later. In factor terminology, value stocks did better than growth stocks.

The growth-into-value rotation stopped around summertime, amid the Delta variant concerns and the market repricing its expectations for tighter central bank policy. That led to technology stocks doing well, driving the growth factor outperformance.

2021 earnings jumped sharply and have surprised on the upside, both in developed and emerging markets. Rebounding economic activity, coupled with still-easy financial conditions, certainly helped. While input cost inflation did create some margin pressures going into the year end, companies have so far been good at passing increases on to the consumer.

Emerging market companies struggled on a relative basis, dragged down by Chinese equities. China’s regulatory crackdown, coupled with its COVID-19 lockdown measures and the appreciating US dollar weighing on investor sentiment. Ex-China emerging markets did modestly better, but still lagged developed country indices. Year-to-date, emerging market equities have returned about 2%, underperforming developed markets by about 17% (see Figure 6).

Figure 6. Differential between emerging and developed markets TR%



¹⁴ All performance data is in US-dollar terms as of October 26, 2021. Source: Bloomberg.

Although we expect earnings to grow at a decent pace in 2022, the overall pricing of equity market beta is quite rich (even its valuation versus bonds has come down to the average level, **see Figure 7**).

There are also clear signals of market froth, with the proliferation of “meme stock trading.” Higher bond yields could also weigh on equity pricing in 2022, the same way that they did in March 2021.

Figure 7. Equity valuations compared to bonds



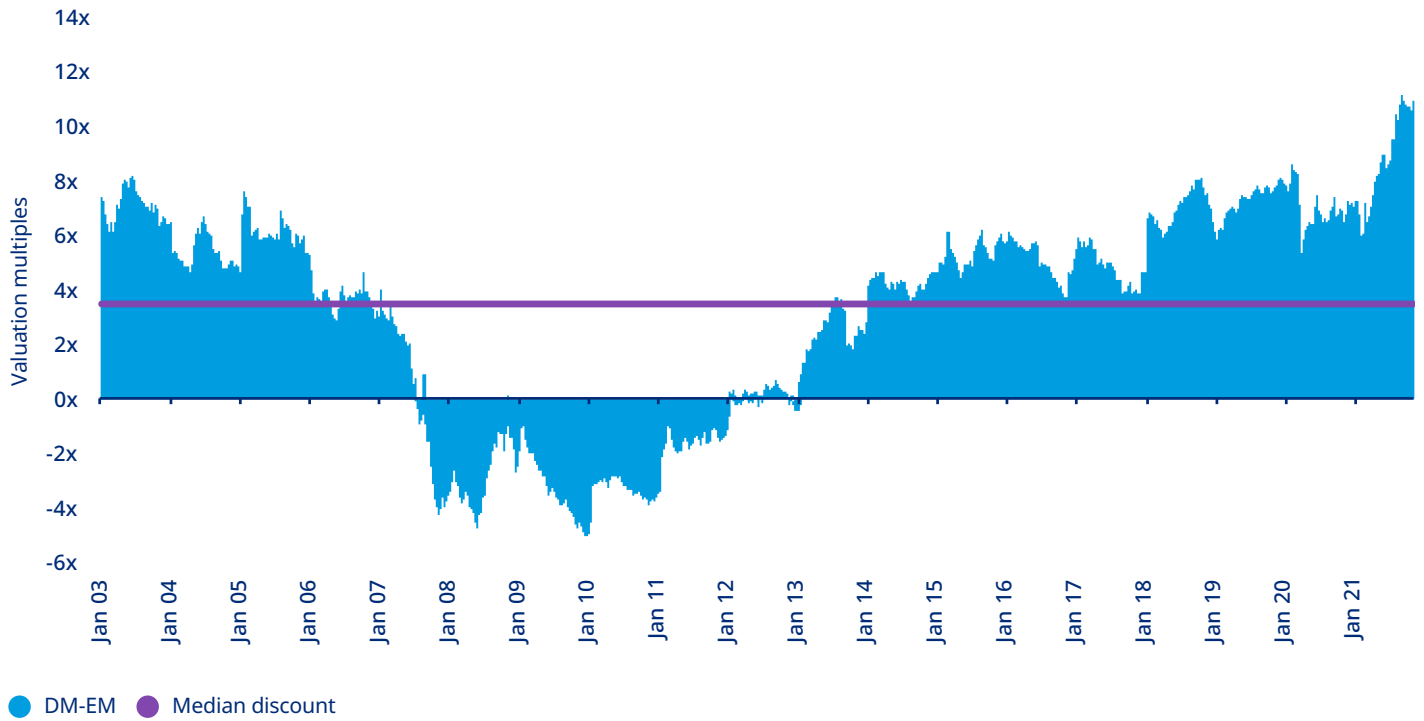
Source: Bloomberg as of October 26, 2021.

*When the line goes above the median, equities are cheap compared to bonds, when the line drops below the media, equities are relatively more expensive.

Within equities, we find pockets of value, with certain regional segments trading at meaningfully lower earnings multiples, but for broad markets as a whole, we remain neutral generally due to their rich valuations. Emerging markets stand out with very attractive valuations, which informs our cautiously optimistic outlook on this sector

(**see Figure 8**). We note the ever-increasing size of China in the emerging market equity complex, as China A-shares are included in broad equity indices. The outlook for small-cap equities is neutral, as a positive earnings outlook is balanced by relatively expensive valuations. We continue to advocate an underweight to defensive equities.

Figure 8. Developed versus emerging market valuation, CAPE measure



Source: Bloomberg as of October 26, 2021.

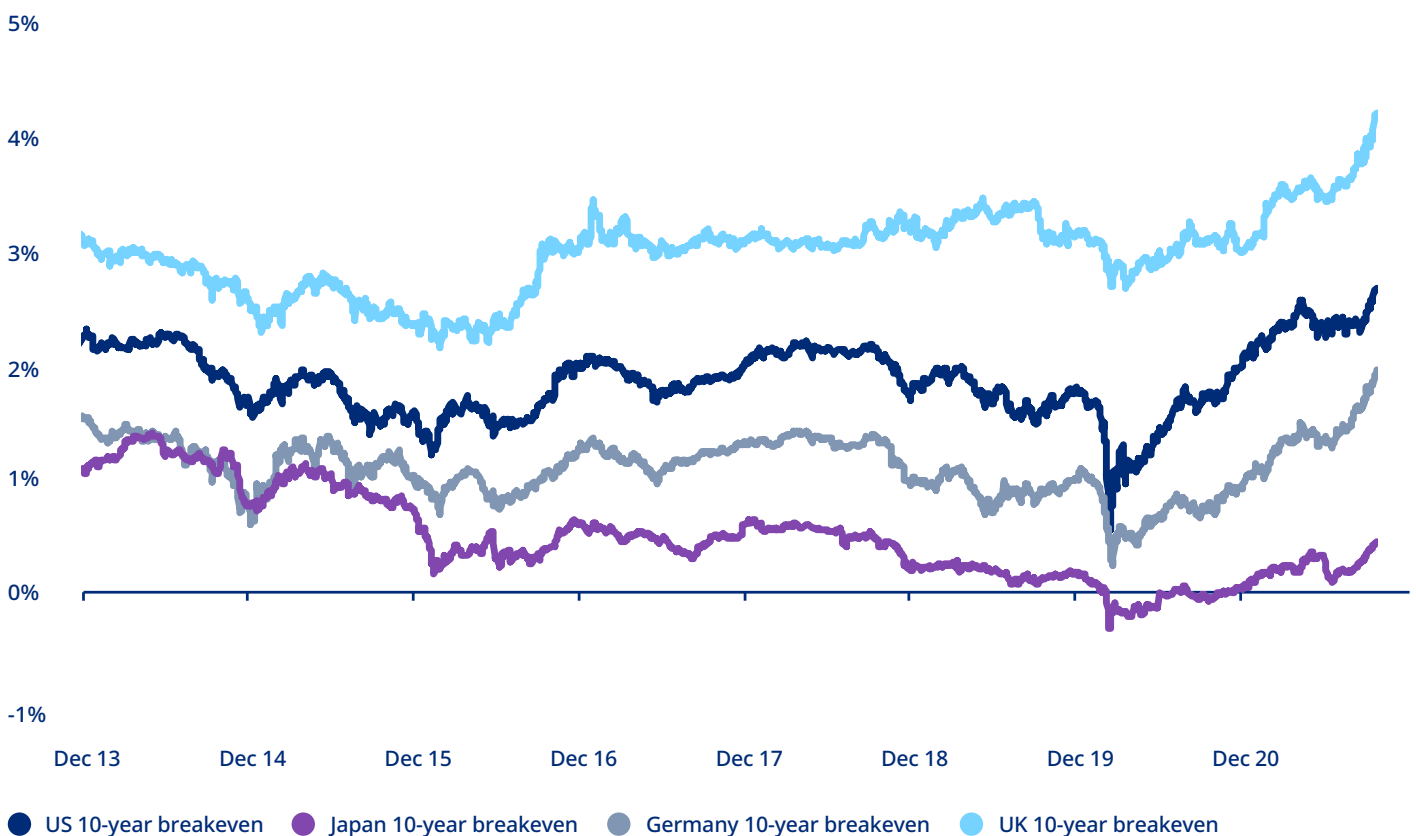
Government bonds

Government bonds sold off sharply at the start of the year, as the markets priced the reflationary environment. US government nominal bonds were off to the third-worst start to a year since 1830,¹⁵ as breakevens (a measure of market-derived long-term inflation expectations) widened sharply (see Figures 9 and 10). Real yields moved up higher, albeit more modestly. In the middle of the year, nominal bonds rallied due to Delta variant concerns and on the back of supportive technical factors, before selling off once again in

September and October. Real bonds (inflation-linked bonds) rallied, generating positive returns overall in 2021.

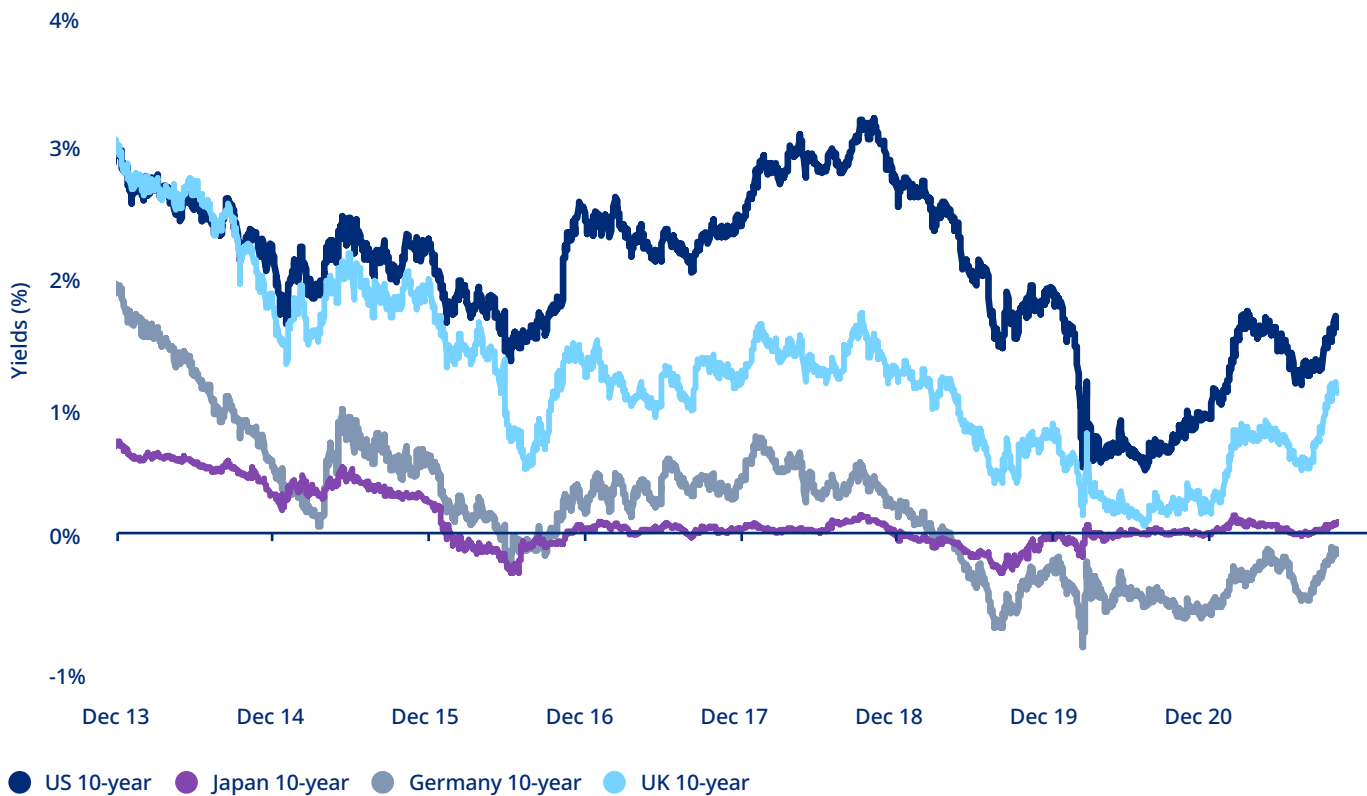
The selloff in nominal bonds was broad across developed market geographies, with the US and UK yields leading the way, followed by UK gilt yields moving up sharply higher, followed by the selloff in eurozone government bonds. Japanese bonds have not moved much, with the central bank controlling the yield curve and inflation expectations still anchored at very low levels.

Figure 9. Breakevens



Source: Bloomberg as of October 26, 2021.

¹⁵ Source: Jim Reid, Deutsche Bank.

Figure 10. Nominal yields

Source: Bloomberg as of October 26, 2021.

We believe bond yields will continue to move higher, although the case for further expansion in breakevens is weakening, especially in the UK, where bonds are already pricing in higher inflation over the next decade and beyond. While it is unclear whether real yields will return to historically more normal levels, the risks appear on the upside. Businesses are spending, governments are spending and climate change initiatives demand capital-

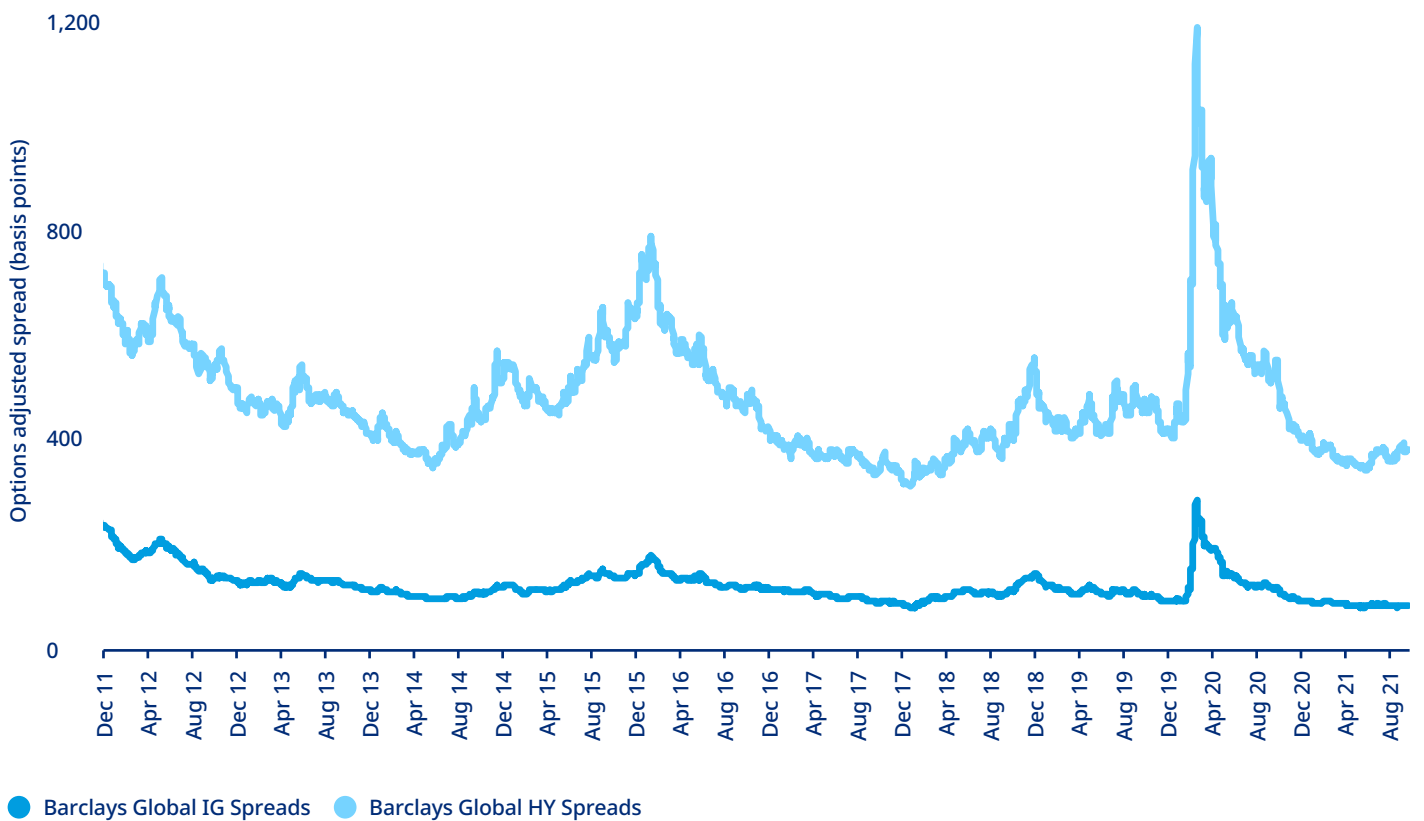
intensive spending — all of these should drive the real cost of capital higher. In addition, central banks are turning less accommodative by winding down their quantitative easing policies and talking about hiking rates, which should also weigh on government bonds. Do we think US 10-year government bond yields will move to 4% next year? No, but we think they will move modestly higher as the economy recovers, inflationary pressures persist and central banks become more hawkish.

Credit

2021 was a fairly muted year in credit markets, with investment-grade corporate bond spreads falling slightly as the global economy recovered. Sub-investment grade (high yield) corporate bonds did somewhat better, although spreads were much more stable than last year. Spreads narrowed/widened in a pattern similar to equity market prices over the year (see Figure 11).

Going forward, we believe both investment-grade and sub-investment-grade spreads offer little compression potential; however, they continue to offer some carry pickup. We believe defaults/downgrades will be low in this environment, whereby “credit easing” is well within the central bank toolkit, if it were ever to become necessary in subsequent crises.

Figure 11. Credit spreads



Source: Bloomberg as of October 26, 2021.

Emerging market debt

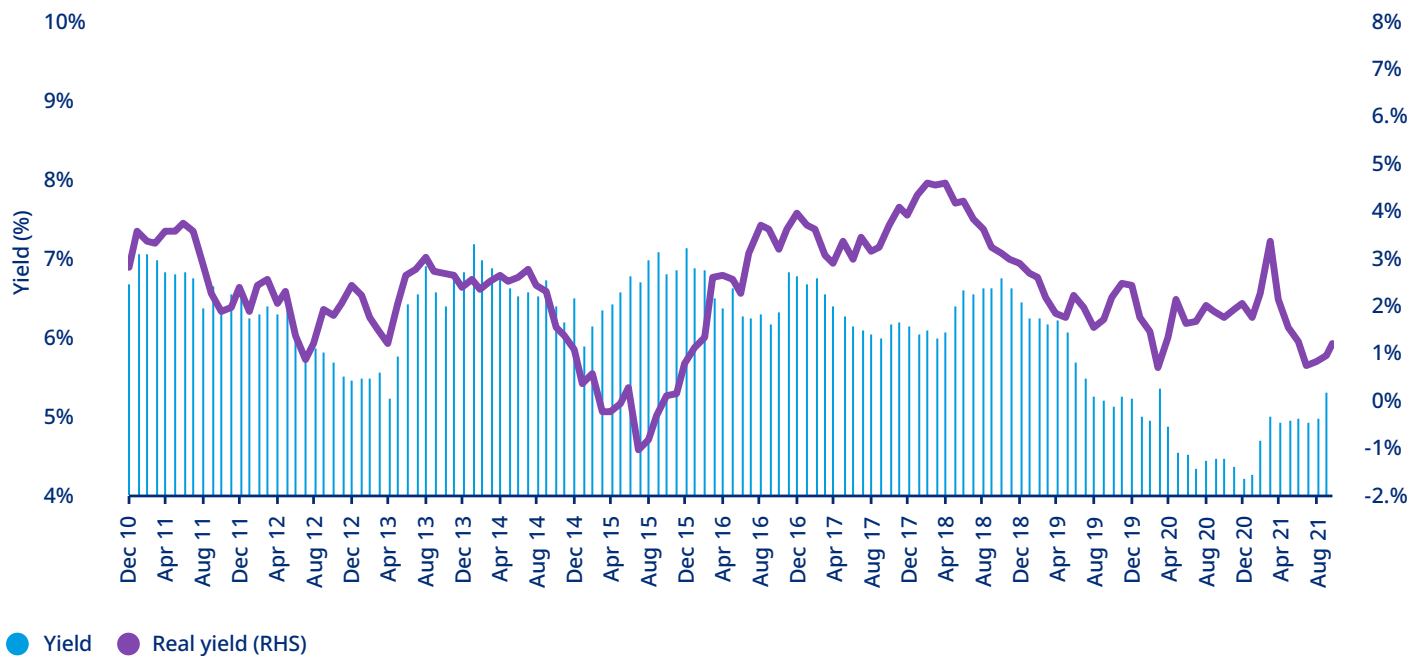
Returns in emerging market local-currency bonds are driven by two factors: the return bonds generate in their local currencies and the performance of those currencies against developed market currencies. Although bonds have broadly held up in local-currency terms (see Figure 12), it was the depreciation in emerging market currencies that dragged down the overall return profile.

Returns in emerging market hard-currency bonds are also driven by two factors: the performance of US government bonds and whether the spreads of emerging market bonds have widened or narrowed. 2021 saw emerging market

spreads narrow (see Figure 13); however, the performance of developed markets duration was negative, leading to overall negative returns.

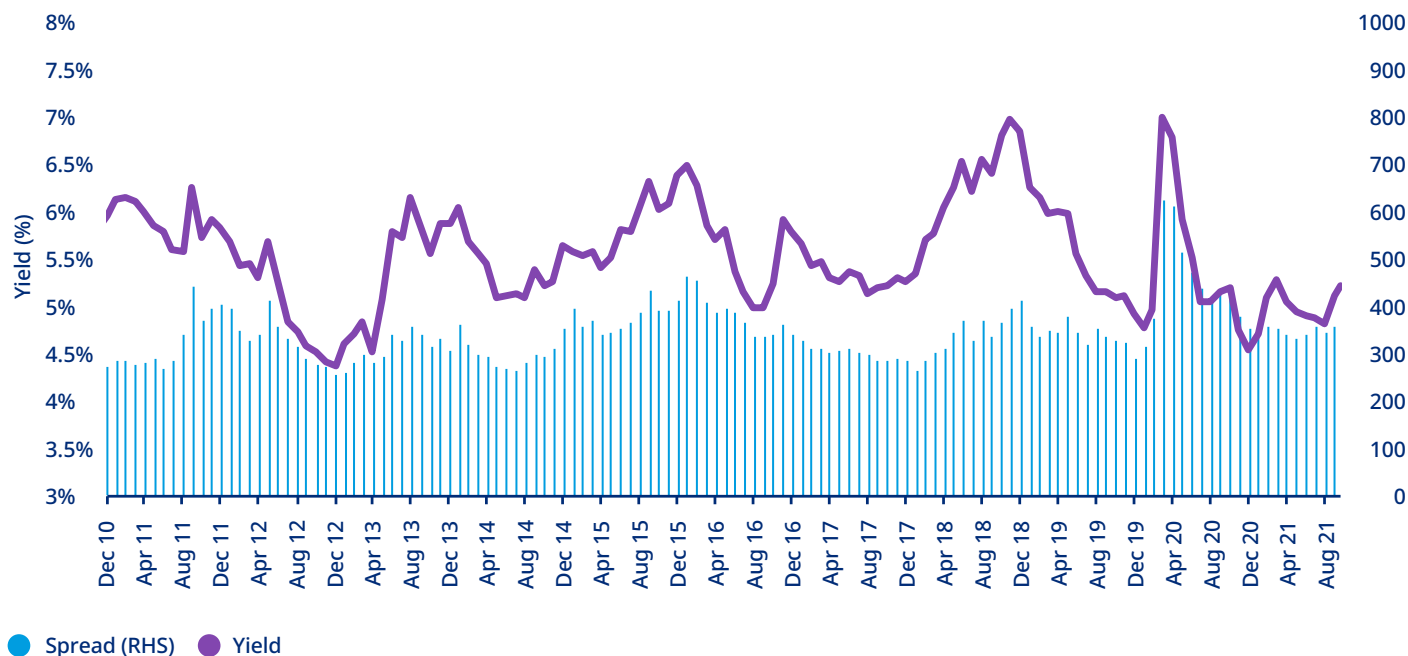
We believe there is a case to be made for emerging market local-currency bonds to do well because of cheap currencies. However, significant risks remain, such as a more hawkish-than-expected Fed that may lead to a stronger USD. The outlook for hard-currency emerging market bonds is positive from a spread-compression perspective, but negative from a developed-market-duration perspective. On balance, we prefer local-currency bonds to hard-currency bonds.

Figure 12. Emerging market debt local currency



Source: Bloomberg as of October 26, 2021.

Figure 13. Emerging market debt hard currency



Source: Bloomberg as of October 26, 2021.

Currencies

At the time of writing, the US dollar continues to be well supported against a basket of developed and emerging market currencies. It is up approximately 4% as measured by the DXY index (see Figure 14). Strong US growth, coupled with higher US bond yields, has underpinned the performance of the global reserve currency. The euro has lagged in 2021, down about 5% as the ECB retained its dovish stance and the eurozone economy lagged the US on a relative basis. One of the biggest movers of the year was the Japanese yen, which depreciated by around 9% against the US dollar, as the Bank of Japan retained its ultra-loose monetary stance and the economy struggled to gather

positive momentum. As noted in the Emerging Markets Debt section, emerging market currencies struggled, down by about 5%.

We are modestly positive on the euro and the yen on valuation grounds, with a slight preference for the euro. Although the US dollar has a few tailwinds behind it, we believe high US inflation, with the twin deficits (fiscal and trade) issues, should weigh on its performance. Emerging market currencies are certainly cheap (see Figure 15) and may have plenty of room to recover; however, we believe the time to buy should be after the Fed surprises the market with a hawkish announcement.

Figure 14. US dollar index

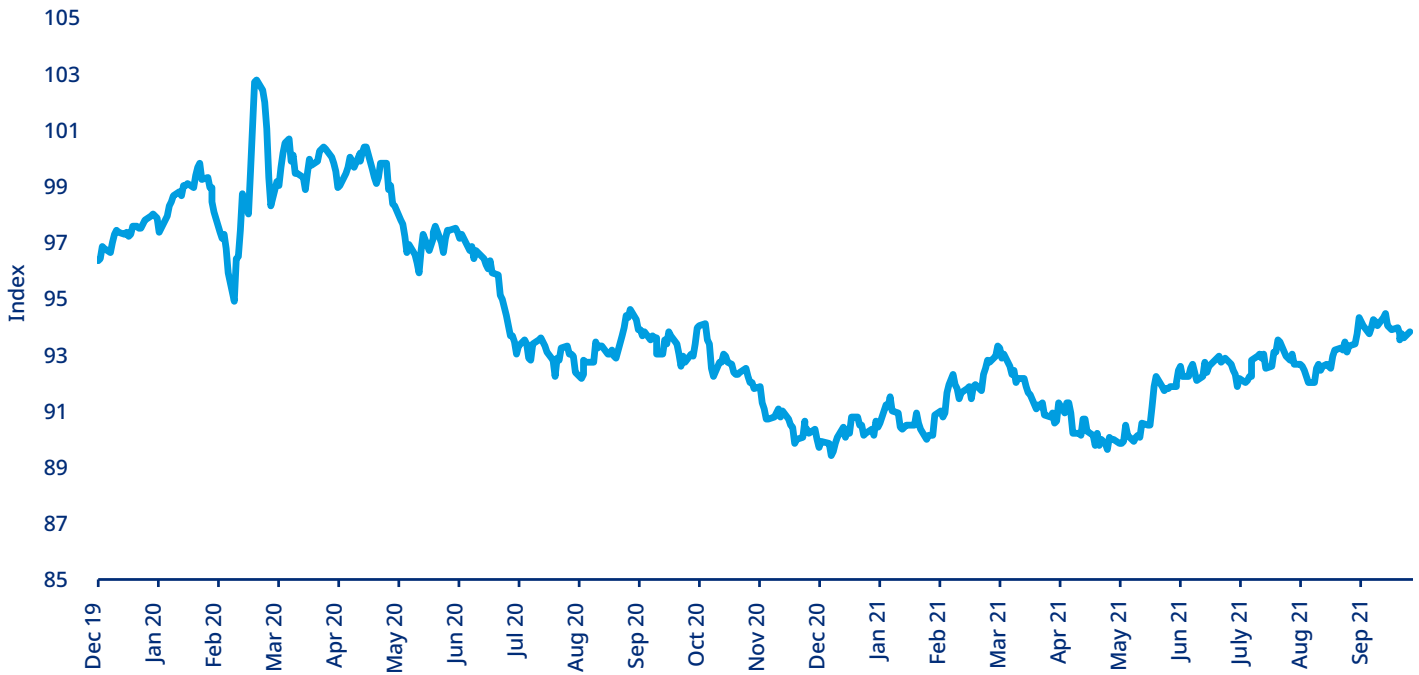
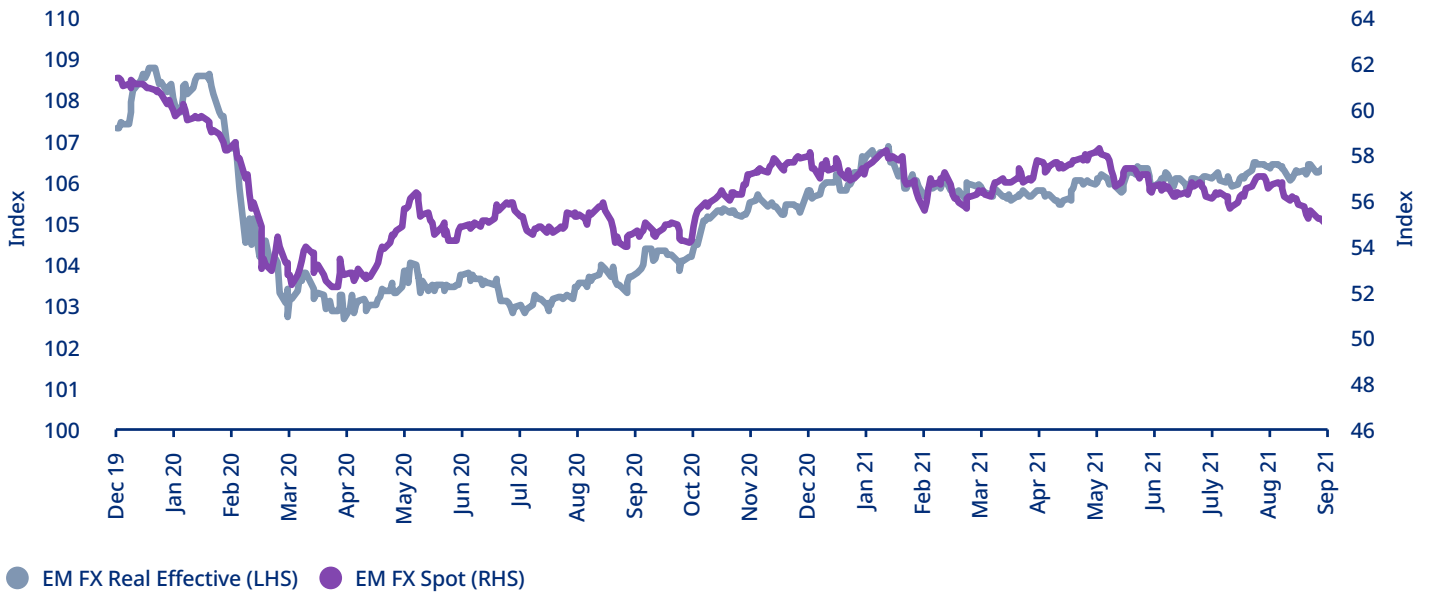


Figure 15. Emerging markets currency index



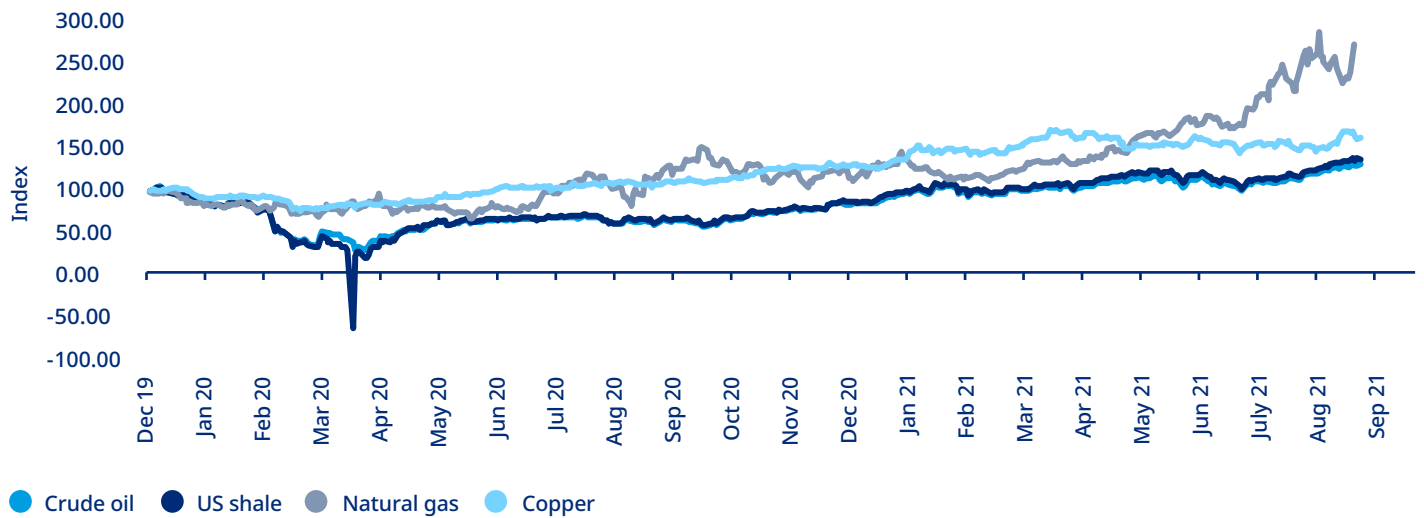
Source: Bloomberg as of October 26, 2021.

Commodities

Commodities have had one of their best years on record. Disrupted supply chains, coupled with booming global demand as economies reopened, have driven energy and industrial metal prices sharply higher. At the time of writing, oil is up about 72% for the year, natural gas in the US rallied by over 100%, while European gas rallied over fourfold

and copper is up approximately 28% (see Figure 16). Soft commodities, such as agriculture, were broadly up. Precious metals, such as silver and gold, struggled as markets were in a risk-on mode, weighing on demand for defensively leaning assets.

Figure 16. Commodity prices



Source: Bloomberg as of October 26, 2021

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