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A member of Prudential plc (UK)

2022 Market Outlook

Normalisation in motion

2022 will likely be characterised as a 'normalisation year' much like what took place in 2004 and 2010, where monetary and fiscal policies start to become less supportive for global growth. Policy makers are expected to tighten after two years of very loose COVID support measures but fading growth momentum amidst rising inflationary pressures is likely to constrain central banks. The possibility of policy errors and changes in market perception are areas to watch.

After contracting sharply in 2020, global growth rebounded strongly in 2021 underpinned by policy support and vaccine roll-outs. Although the recovery is ongoing, it has moderated and remains uneven. The ongoing disruptions caused by the spread of the Delta variant and the threat posed by emerging new variants of concern, and supply chain bottlenecks continue to challenge growth and inflation.

IMPACT OF POLICY SHIFTS

We expect any tightening, be it tapering or rate hikes to have a modest half a percent impact on global growth, in line with a mid-cycle slowdown. From a big picture perspective, growth should remain in positive territory. We expect the service sector to provide the next leg up in growth and pick up the slack from manufacturing as COVID pills from Merck and Pfizer are added to the toolkit, fanning the flames of the 'reopening trade'.

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In this environment, equity markets could see some setback in the order of a 5-10% reset that we saw in 2004 and 2010, as they digest the inflation and tightening cycle. Valuations are modestly expensive which creates heightened conditions for a market sell-off.

Markets are however pricing in fewer rate hikes after 2023 versus the US Federal Reserve's (Fed) forecast[1] but in the near

Source: [1]As at 19 November 2021.

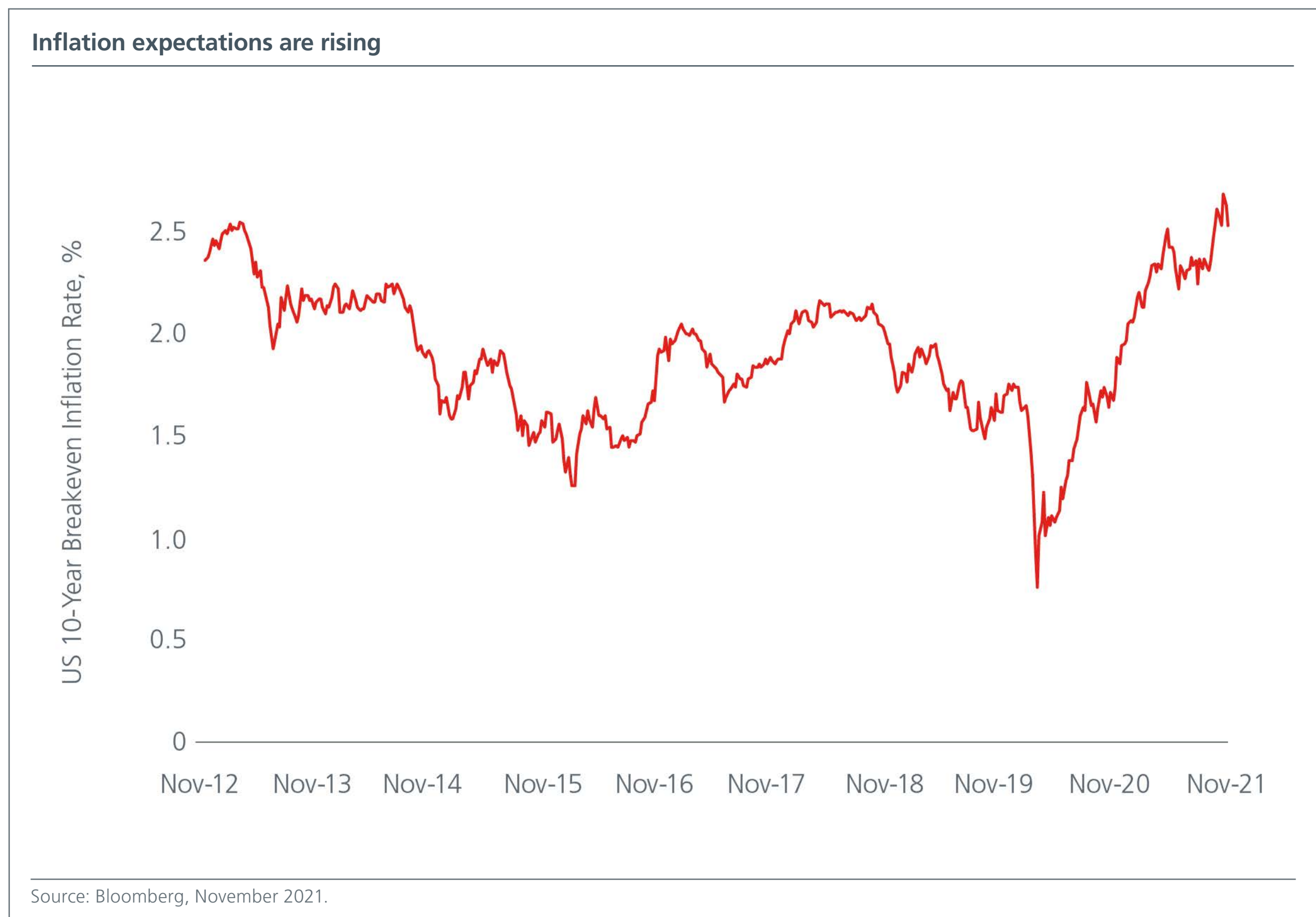
term, policy makers are likely to shift to a tighter stance. The risk is that central banks may respond aggressively to inflationary pressures with a more rapid tightening of policy.

On tapering, we do not think it will be as big a shock for bond investors this time round. They have been preparing for policy normalisation since late 2020, in contrast to 2013 when the unexpected announcement resulted in the well-known taper tantrum. But more importantly, Emerging Markets (EMs) are in a stronger position today. Countries such as India and Indonesia are showing balance of payment surpluses instead of deficits and EM bonds in aggregate are offering higher yield pick-up versus US treasuries compared to 2013.

INFLATION IS A STICKY ISSUE

The market's perception of global inflation risk will likely dominate as the key theme for investors looking ahead. While we believe many of the current inflationary pressures, namely supply chain constraints and the tight supply in the energy markets, are likely to dissipate as lockdowns ease, there is mounting concern around spillover effects into wage inflation. There is a risk that the Fed is behind the curve on inflation which could then lead to more aggressive tightening. Navigating this risk will be key to generating compelling investment returns.

With regard to commodities, we expect prices to go up in line with the typical decade-long cycles. Pricing pressures



Source: Bloomberg, November 2021.

will result as supply falls behind demand. This phase will likely persist till we see supplies ratcheting up again. In Asia, the inflation sensitivity of the economies in the region to higher energy prices has historically been relatively muted due to factors such as price rigidities, the nature of electricity pricing agreements, and time lags.

Although Asia is a commodity importer, Asian central banks have had a track record of looking past commodity price increases, viewing them as transitory and a tax on growth, rather than having sustained impact on wages or broader prices. Asia has also struggled with unemployment or under-employment since the 2008 Global Financial Crisis. Furthermore, the last two years of tightened mobility measures have worsened Asia's labour market slack and this will constrain commodity prices from broadening into more general price pressures.

INVESTMENT IMPLICATIONS

Equities – We remain moderately bullish on equities, given where we are in the economic cycle. Growth could have another round of upside surprise, giving equities a leg up but we are far from the market's unanimous bullish stance seen in 2020. Given the expensive valuations, particularly in the US, we are looking for more tactical opportunities. We expect the market environment to be more volatile. Ongoing supply chain security issues will also have implications for capital expenditure which is why we are starting to be bullish on sectors such as materials and industrials over the medium term.

We expect EMs to do better than the Developed Markets given the expensive equity valuations in the US and faster tightening cycle. The EM view is anchored less on the EM reopening trade, given China's continued pursuit of a zero COVID policy, but more on a favourable view of policy stabilisation. Within EMs, we expect pockets of attractive opportunities to dominate and one which we are watching closely is China tech versus US tech given the challenges the sector has faced in the past six to nine months.

Value stocks are also expected to do well in the year ahead amid the ongoing economic recovery. Value has been lagging and there is room for catch up. However, the duration of this catch up will likely depend on the market's perception on the path of interest rates.

Bonds – While we remain bullish on equities, we also see value in bonds. In the US, on a longer-term perspective, the view is in favour of US High Yield bonds relative to US Investment Grade bonds. Given the sanguine inflation outlook in Asia, we are less worried about rate hikes. Outside of Korea and Singapore, we see limited policy appetite to tighten ahead of the Fed, and central banks are likely to keep rates on hold in Thailand and Indonesia. This offers tactical trading opportunities in Asian local currency government bonds based on differing interest rate outlooks and debt dynamics within the region. We also expect the improving Asian growth outlook in 2022 to attract capital and foreign direct investment flows, giving a stronger potential for Asian currencies to strengthen against the US Dollar.

As for Asian credits, while the Asian High Yield sector has taken a hit given the ongoing default risks faced by China's property sector, there are still good investment opportunities. Careful credit selection is required to seize alpha in this segment. Meanwhile, the order books for Asian High Grade bonds have remained healthy. We believe the current global growth forecasts will remain supportive of risk assets. Asian credits will likely continue to benefit from the global search for yield.

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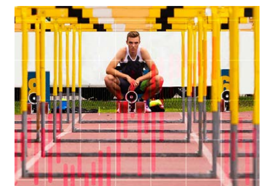
China redefined

Underappreciated Asia

ESG accelerated



Continuous disruption

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