BARINGS

— 2022 OUTLOOK —

THE NEW NORMAL COMES INTO VIEW

Economic Outlook Roundtable

The global economic recovery looks set to continue in 2022, but a number of risks remain—from tangled supply chains to lingering price pressures. Join our panel of experts as they explore these issues from both the "top-down" and "bottom-up."

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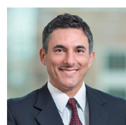

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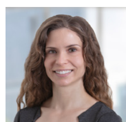

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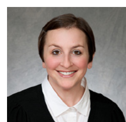

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Christopher: While there are still plenty of uncertainties and unknowns ahead, the pandemic seems more contained in developed markets versus a year ago. Alexandra, talk us through the patterns in developed and emerging markets in terms of the rollout of vaccines and the risks that we may see further lockdowns.

Alexandra: In the absence of the emergence of a new variant that has significantly higher levels of immune escape, we believe the risk of extensive and prolonged lockdowns in developed markets is still fairly low, as we now have a relatively high percentage of populations vaccinated. The picture in emerging markets is less clear. We have enough capacity in 2022 to vaccinate the world, but there are some bottlenecks in terms of distributions and getting jabs into arms. In markets where the virus has been spreading for some time, we're reaching some form of herd immunity.

"Another positive, and one that tends to be overlooked, is global trade is growing quite briskly after lagging from 2008 through 2020, which is supportive of both the world economy and emerging markets."

Christopher: Ricardo, what do you think about the momentum going into next year for global demands as governments consider withdrawing their support both on the monetary and fiscal side?

Ricardo: The U.S. Federal Reserve (Fed) has said they have effectively met the inflation objective of the dual mandate, so we are going into 2022 with self-sustaining growth, which is very good for the global economy and the emerging market space. But at the same time, we're having some retrenchment of monetary accommodation. Indications from key policy makers, especially in the developed world, suggest accommodation will not be withdrawn drastically, which could give emerging markets time to either fully vaccinate or make significant progress in the battle against COVID like the developed markets have.

Another positive, and one that tends to be overlooked, is global trade is growing quite briskly after lagging from 2008 through 2020, which is supportive of both the world economy and emerging markets.

Christopher: Emerging markets have struggled this year, in part due to the fact that the rate expectations in the U.S. have picked up and the dollar has been strong. Will those headwinds persist next year?

Ricardo: Most likely, yes. But it's important to note that within the emerging markets space, there is tremendous variation from country to country. We have countries with economies that are similar to developed markets, many of which have the ability to borrow from their very deep domestic markets. And then there are smaller economies that are more dependent on external funding. These countries tend to get hit harder in every crisis—the pandemic was no exception—and may continue to struggle next year amid inflationary pressures.

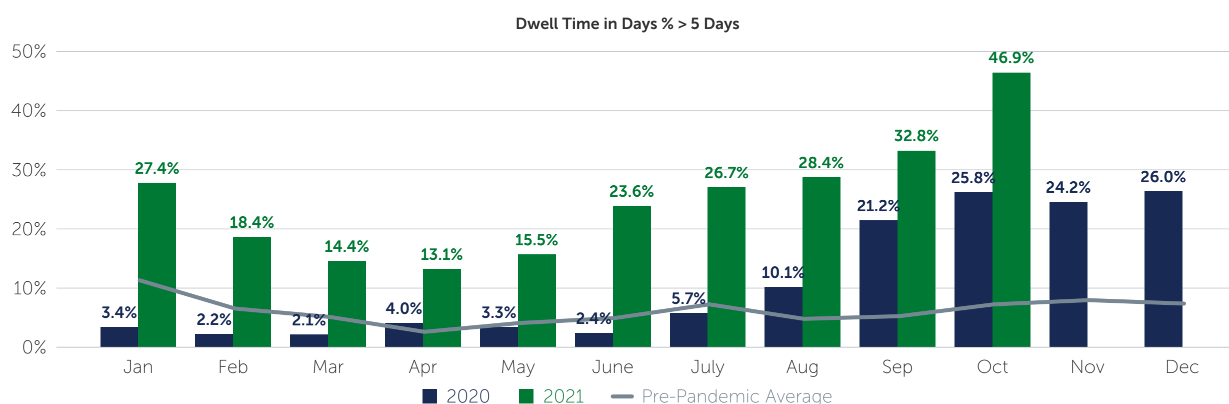
Christopher: Julie, you follow supply chain issues closely. Why have they broken down so spectacularly, and how soon can we expect them to heal?

Julie: The short answer is, it's complicated and there isn't a quick fix. People are so fundamental to the shipping, storing and receiving of goods. When things reopened, there were new COVID protocols in place that led to a less efficient workforce. In some regions, we continue to see ongoing COVID-related shutdowns, so we either need more people or more automation.

Over 70% of our goods are ultimately delivered by truck. According to the ATA, we need another 80,000 truck drivers to meet current demand in the U.S., and we've been facing this shortage for a while; the hours of service requirements, drug testing policies, and an aging cohort were all issues prior to 2020. Against this backdrop, I expect we're in for a difficult 12 to 18 months before things start to normalize.

Outside of the U.S., European markets are facing the same issues with truck drivers, and some Asian markets that have a zero-tolerance policy are experiencing more shutdowns and facing similar issues.

Figure 1: Pedro Bay—West Coast Port Congestion Indicator



Source: PMSA. As of October 31, 2021.

Christopher: James, you live in Hong Kong, one of the most important links in the world's supply chains. How well has trade returned to normal, and what disruptions are we going to see in the months ahead?

James: I definitely share Julie's view—it is a global issue and it's quite evident in Asia as well. Although trade activity in China has been encouraging, with strong shipments to developed markets including the U.S. and Europe, bottleneck constraints remain high. Some of the increases in nominal exports are surely owed to steep price increases. But over the next few quarters, we expect COVID-related backups at some Chinese ports to fade. In Japan, auto-related firms are pointing to production cutbacks from persistent semiconductor shortages and noted difficulties in getting parts from Southeast Asia. So that problem is not going away any time soon.

Christopher: Beyond port capacity, there are other factors investors are focusing on in your part of the world. How serious are headwinds such as regulatory enforcement, property disruptions, or electricity shortages for the Chinese economy?

James: The property downturn has weakened fixed asset investment, and the zero-COVID policy certainly inhibits consumption recovery. But if GDP growth slows sharply in the coming months, we expect some sort of easing from the government in terms of fiscal and monetary policies to support growth—and, more importantly, to prevent a property-led hard landing. As an example, the recent PBOC announcement of the new green lending tool is a first step toward targeted easing to offset the downward pressure on growth, at least in the short term, which could also help achieve the longer-term goal of decarbonization. Combined with anticipated targeted easing measures in other areas, we hope to see some sort of engineered modest recovery in Chinese growth next year and, in the broader sense, we're expecting uneven global growth next year.

Christopher: Abby, what can we expect in the U.S. and Europe? We've got a very tight housing market in the U.S. On the office and the commercial side, questions remain around how many people will return to the office. What sort of usage patterns will remain after the pandemic?

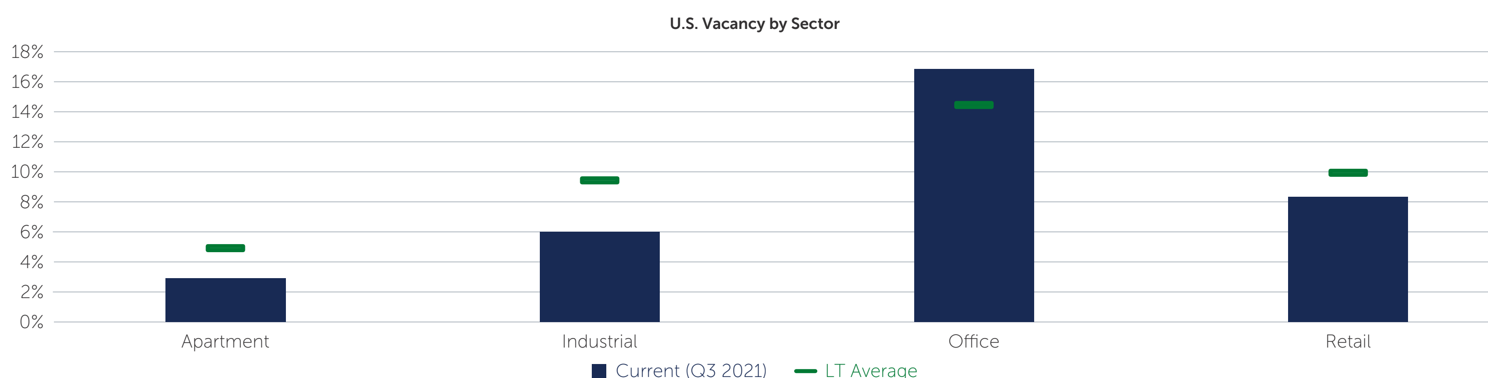
Abby: I'll start with the good news, which is that occupier demand is strengthening and fundamentals are improving across all major property types, including office and retail—where we've seen the most challenges—and we expect that trend will continue into next year. Apartment and industrial have had the strongest performance. Even though apartment was not immune to effects from COVID, vacancy is declining across most U.S. markets. Rent growth has returned and concessions have burned off. Even as an increase in multi-family permits signals near-term elevated new supply, strong secular tailwinds from housing demand and household formation should translate into a healthy performance in the coming quarters.

In the industrial sector, strong global trade conditions, improved manufacturing data, and elevated e-commerce as share of total retail sales have been a tailwind for industrial performance. The recovery has been so robust that the industrial availability rate is currently at its historic low, and we expect consumption and trade activity will hold up in the near term, which should drive healthy industrial rent growth and a positive outlook in the coming year.

Two sectors facing greater challenges are office and retail. Work-from-home continues to be a headwind for office, although the sector is starting to see signs of stabilization. We believe physical offices will remain an important part of company culture, even as we transition to a hybrid workplace, so we're focusing on high-quality space both in the suburbs and Central Business Districts.

In Europe, we're seeing similar patterns—particularly in the apartment and industrial sectors. For the office sector, the recovery is a bit further along than it is in the U.S. simply because we've seen more workers return to the office.

Figure 2: U.S. Real Estate Trends



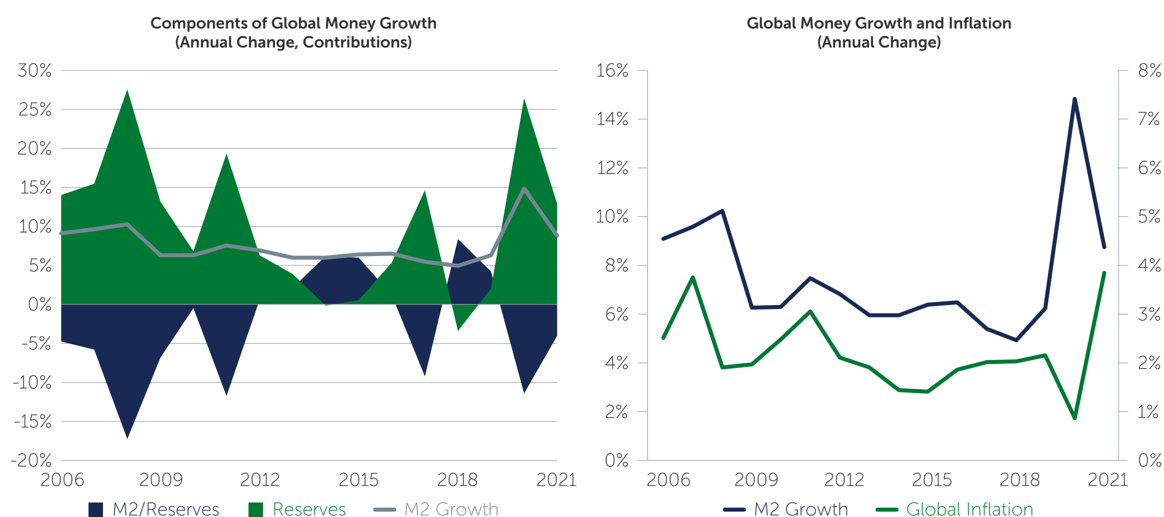
Source: CBRE Econometric Advisors. As of Q3 2021.

Christopher: Ricardo, this is a complicated picture as there's both tightness and slack in the global economy. Are you worried about lingering inflation?

Ricardo: We like 10-year and 30-year bonds, and those shouldn't be affected by near-term inflation, as in two to three years. Near-term inflation is very strong, and we think the trends that caused interest rates to come down for so long—primarily demographics, and the reduction in births that is causing declining population growth—are still in place.

Something that is typically not talked about is quantity of money. In this case, we're focusing on money aggregate M2, which is basically the sum of deposits (created by commercial banks) plus reserves (created by central banks). We're going into the next year with the view that central banks have realized they're creating too much money. In 2009, banks undid almost everything that central banks did. Central banks created roughly 25% extra money, and banks took out about 20% of that. So the money creation went to about 5%, and there was no inflation. In 2021, we had central banks creating 26% extra money, but—because the pandemic wasn't a financial crisis—banks didn't take out as much, only about 10%.

Figure 3: Beware of QE Removal



Sources: Haver Analytics; Bloomberg; Barings estimates.

Now, we have central banks retrenching their QE, reducing the pace of reserves, and beginning to talk about taking reserves out of the system. We need commercial banks to create money, M2. Otherwise we will certainly go back to pre-pandemic trends, which were for lower inflation and very low interest rates.

"I do expect some diversification away from China, but with the port issues we're facing, nearshoring to places like Mexico is becoming more appealing."

Christopher: James, from your perspective, what is it that you're most worried about in terms of inflationary pressures?

James: Many firms have been able to protect margins with very strong pricing power, at least for the moment. That's good for corporate profits, but the concern that consumers are starting to build-in inflation expectations is actually quite valid and worrisome. Given still-healthy profit margins, a company should be eager to ramp up the production as soon as supply normalizes, which will help ease price pressure eventually. However, it does take time for the market to find a new equilibrium, so I expect firm prices to be extended through at least the first half of next year.

Christopher: Julie, supply chain disruptions have led to broad pronouncements about the end of globalization. What investment opportunities do you think are most interesting, and do you believe they will reflect supply chains being pulled closer back to home?

Julie: I don't think globalization is dead; it's always evolving. I do expect some diversification away from China, but with the port issues we're facing, nearshoring to places like Mexico is becoming more appealing. There's a lot of excitement in logistics around the connected Canada/U.S./Mexico supply chain, so the ability to utilize surface transportation over roads or rails minimizes the complexity, and some of the cost uncertainty, compared to overseas shipping.

One of the big lessons here is that it's really risky to have a single supply source. I don't think we'll abandon overseas manufacturing, but things coming nearer to home is going to be in play. We're looking at ways to invest in transportation networks that help alleviate bottlenecks. An example of this would be developing new points of access to the less-utilized West Coast ports. We also continue to keep an eye on Level 4 autonomy for Class A trucks, which allows a truck to be driver-free under limited conditions. Not only would this reduce the requirement for truck drivers, but it could also allow vehicles to be run 24 hours a day, which increases utilization of equipment.

Christopher: If globalization isn't dead and we're going to see a reorientation of supply chains, is the reliance on just-in-time delivery dead? I think not just relying on a single supplier, but carrying limited inventory, is what helps boost profits. Are companies going to rethink that?

Julie: I think we'll have an increase in inventory over the next three years, but then people will forget about all these issues and go back to what we were doing before and try to maximize profits and keep the minimum supply in their warehouses. So, over the short term, yes. Long term, probably not.

Christopher: Abby, do you think those inventory issues will go away? And, more broadly, where do you see opportunities in real estate?

Abby: Since inventories are quite low for retailers, the store will continue to be such an essential component of a retailer's strategy. The last-mile distribution factor for stores has become so important since the pandemic hit, whether it be in-store shopping, curbside, click-and-collect, or delivery. I think these supply chain disruptions are going to be acute over the holiday shopping season, but retailers are becoming more savvy with how they are getting the goods to consumers.

Brick and mortar retail is going to be incredibly important, so well-located centers with great omni-channel capabilities that are resilient to e-commerce look to be best-positioned going forward. In other sectors, we're focusing on STEM markets: Science, Technology, Engineering and Math—places with research and universities that tend to attract people and are seeing the greatest population growth. In particular, we're focusing on suburban apartments and high-quality/hybrid office properties in those areas. For industrial, we're focusing on emerging sub-markets for last mile properties in those top 20 metros that we track, and first mile properties in emerging regional distribution nodes (close to population clusters) with excellent infrastructure and labor availability.

Christopher: James, you mentioned equities look particularly good as you put together a multi-asset portfolio going into next year. What other areas are you keeping a closer eye on?

James: Multi-asset investing is never easy and it's getting more challenging every year. We go back to the basics of investment cycle investing, whereby style selection gives us a clearer signal. Since we are past the peak of economic growth in most developed economies, stocks that exhibit quality and growth styles, in our opinion, are the best when growth moderates, which we think it would, over the next year or so. Our portfolios are already tilted this way, and I expect the style positioning to work well into 2022.

We still prefer the U.S. given its earnings visibility and high exposure to technology companies. We see the Japanese market having potential to catch up with other developed markets, with the reopening complemented by a strong earnings rebound, ongoing expansion, monetary policy, and potential sizable fiscal stimulus, which should be quite supportive for domestic equities from a top-down perspective.

Christopher: Ricardo, you look at sovereigns in the developed world, as well as the emerging world, and currencies globally. What opportunities do you expect to focus on next year?

Ricardo: The biggest opportunities seem to be within the credit space, particularly BB sovereigns. Of course, there are certain single-B countries that are putting up a very good fight, and we think they will do extremely well. But broadly speaking, BBs seem to be better-positioned. There also seem to be some opportunities in local rates, since interest rates in emerging markets have not followed the path of developed market rates. For instance, for countries like Mexico, Russia, Brazil—which have seen a similar range of inflation as some developed markets—interest rates have not moved. And finally, currencies continue to look cheap relative to history, presenting potentially attractive opportunities.

This piece was adapted from a virtual panel discussion. Listen to the podcast version here.*

*Full Podcast URL: https://www.barings.com/institute/2022-economic-outlook_pod

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