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RESEARCH NOTE

Central Banks Walk a Tightrope

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A new year is upon us, and while many of last year's concerns remain—COVID, U.S. inflation, and China's property sector—2022 is ushering in a new set of opportunities and challenges, notably for central banks**. Even if investors may be skittish and markets volatile, we still expect policy to support growth above-trend as price pressures recede—a good environment for risk assets.**

Omicron is a persistent reminder that the pandemic is not yet behind us. Record contagion is weighing on activity—largely through self-restraint rather than government restrictions. However, the impact to growth appears to be less severe than last winter—and less than was initially feared. This suggests that **Omicron will lead to a temporary setback, rather than a derailment of growth across the globe**.

Nevertheless, **inflation fears are rising** as U.S. CPI reaches a four decade-high. Protracted supply constraints continue to be a key driver, though a broadening in price pressures is taking place. The impact of the newest COVID wave on inflation has yet to be seen, but **further disruptions to the supply of both labor and goods could add to near-term stickiness—or work the other way as a temporary slowdown in growth hurts consumer sentiment and delays savings deployment**. While inflation is rising in the euro area as well, it is largely a function of higher energy prices.

China's property sector remains a key risk to the region's recovery, as does its zero-COVID policy. However, additional policy support, strong external demand, and a rebound in the manufacturing sector should keep the Chinese recovery on track.

With U.S. inflation well above the Fed's average 2% target and a slower return of labor supply leading to a local full-employment environment, **the FOMC has made a hawkish pivot**. The stimulus boost is fading, as most major economies face tighter monetary policy and less fiscal support while growth begins to normalize in 2022**. The central question for markets is: will the Fed deliver the correct dose of tightening to keep the recovery alive?**

This question leads us to track three scenarios over the next 12-18 months.

We believe **the Fed and the world's major central banks will manage to strike <u>A Fine Balance</u> as they normalize monetary policy. While protracted supply constraints and new COVID waves are making a return-to-normal increasingly volatile, growth should remain strong and inflation should trend lower in the second half of 2022 as supply and demand normalize**. Western central banks aim for a gradual tightening of financial conditions to ensure a downward path for inflation, while preserving the strong economic recovery. They will remain agile and responsive to incoming data, but patient so as not to unnecessarily slow growth. **Our central scenario will be favorable for risk assets, credit, and private markets and sees the 10-year U.S. Treasury yield end the period at 2% following several rate hikes. This scenario carries 60% odds.**

We call our first alternative scenario **<u>Runaway Train</u>** and assign it 30% odds. The forces driving higher prices still weaken but do not peter out entirely, and inflation stabilizes at a higher level than before the pandemic. **Central banks tighten too gradually or without much impact, leading to both elevated growth and persistent inflation pressures through 2H22**.

Our third scenario remains Gravity Prevails, with 10% odds. In this case, after households spend their savings, demand normalizes while fiscal support fades. Central bank tightening proves too much with both **growth and inflation falling back to lackluster levels, typical of the pre-pandemic era**. Risks loom large on the outlook as data-dependent central banks search for the right path ahead, but our bet is that they will proceed with caution. The adjustment of supply and demand should ease inflation pressures, allowing central banks to accompany the recovery without excessive tightening.