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Glovista Global Perspectives

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2022 Outlook: Continuing Economic Recovery, Declining Inflation, and Sustained Equities Allocation with Tilt toward Quality and Value

In 2021 global economic performance has proven satisfactory at the activity level. However, within the price domain, performance has been markedly less so, with inflation surprising to the upside across most of the world's regions. Table 1 contrasts 2021 calendar year consensus GDP and CPI inflation estimates held as of the beginning of December 2021 against those prevailing as of January 2021.

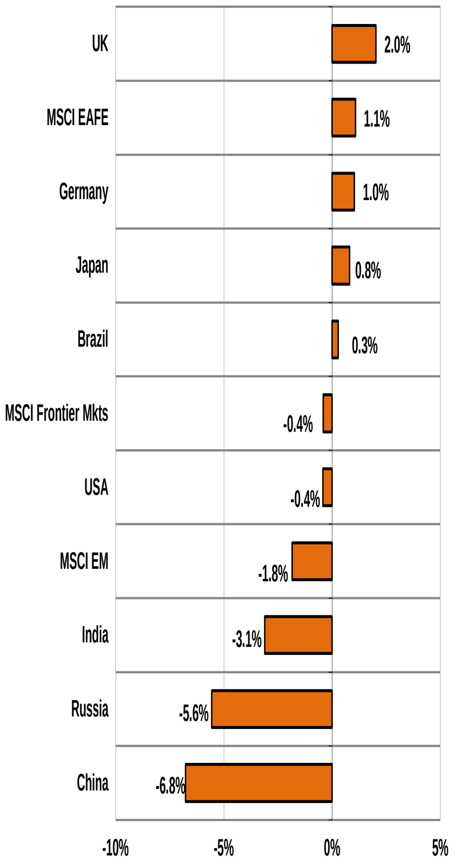
Table 1. 2021 World Real GDP Growth Accelerates though at Considerably Higher than Expected Inflation Levels

	As of Dec 31st 2020		As of Nov 30th 2021	
	GDP Growth Est YoY %	CPI Est YoY %	GDP Growth Est YoY %	CPI Est YoY %
Global	5.2	2.7	5.8	3.7
Developed Economies	4.0	1.6	5.1	3.3
Emerging Economies	5.1	3.4	6.4	3.5
USA	3.9	2.0	5.5	4.5
China	8.2	1.6	8.0	1.0
Euro Area	4.6	0.9	5.1	2.5
Japan	2.7	0.1	2.0	(0.2)
India	9.1	4.5	9.1	5.4
Brazil	3.5	3.5	5.0	8.3

Source: Bloomberg Consensus

As we look ahead to 2022, we expect activity recovery to extend with an accompanying narrowing of output gaps across most of the world. As for inflation, we foresee sustained declines owing to a number of factors, including: benign year-ago base price effects in the energy and agriculture commodity space; fading of supply chain disruptions, and; lagged effects from 2021 policy rate hikes and tightening conditions (including recent US Dollar strength).

Country-wise Monthly Performance in USD terms (December 2021)*



Source: MSCI & Bloomberg

**As of December 20th, 2021*

S&P500 Monthly Sector Performance –December MTD 2021*

Sectors	% Change	FY1 PE Ratio
Energy	-1.66%	13.3
Materials	1.47%	16.6
Industrials	-0.10%	26.3
Cons Disc	-5.96%	34.2
Cons Stap	6.65%	22.3
Technology	-1.63%	27.9
Healthcare	5.50%	17.9
Financials	-0.50%	13.0
Utilities	6.34%	21.0
Telecom	0.15%	20.3
Real Estate	4.55%	45.5
S&P500	0.02%	21.9

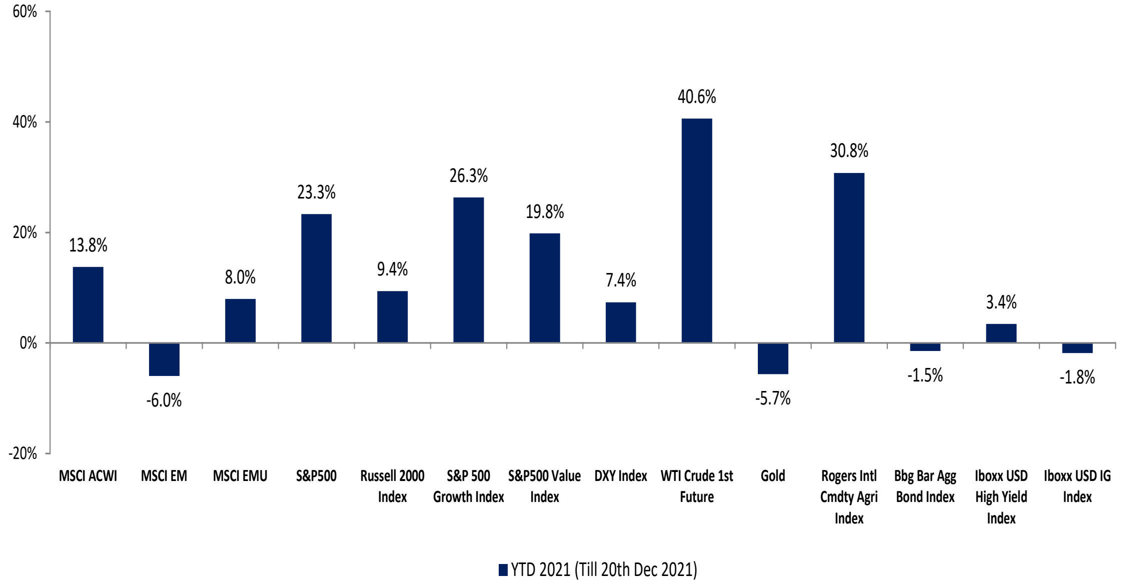
*As of December 20th, 2021

Source: Bloomberg

2021 Year Review: Risk Markets Performed Strongly, despite Rising Inflation, as Activity Recovery Sustained Courtesy of Vaccination and Policy Support

In 2021 risk markets have performed strongly, supported by activity recovery and attractive relative valuations prevailing early in the year. The recovery has been aided by this year's largely successful global vaccination program as well as continued policy support on the fiscal and monetary sides, especially in the developed world. Figure 1 illustrates 2021 year-to-date US$ total return performance across major asset groups.

Figure 1. Risk Assets Post Solid Returns in 2021



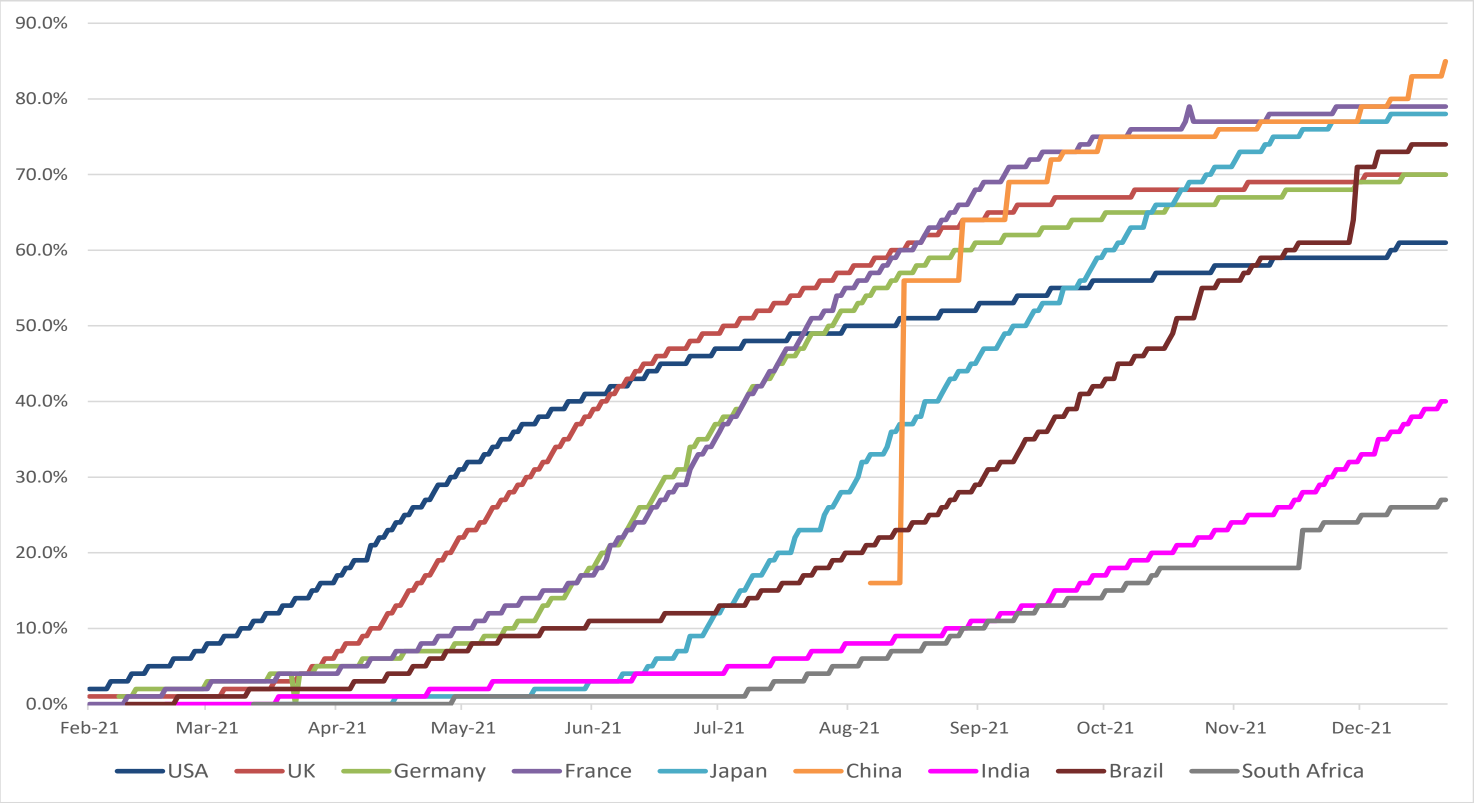
Source: Bloomberg & Glovista Calculations

Figure 2 illustrates the degree of success attained on the global vaccination efforts launched early in 2021. Of course, success is still incomplete as the remaining pool of unvaccinated and partially vaccinated population globally is still large enough to provide the virus fertile grounds from which to produce new strains with unknown lethality. Despite such continued concerns, investors find comfort in the views held by the virologist community that expects the lethality of any future strains to be manageable for global healthcare systems given the protection afforded by existing vaccines, the large and growing share of the world's vaccinated population and the agility and effectiveness of the new MRNA technology in responding to new strains.

Advances on the vaccination front along with lax, yet recently tightening, financial conditions have helped sustain the 2021 economic expansion. Figure 3 illustrates continued upside momentum recorded by the global goods and service sectors of the economy in 2021 while Figure 4 shows continued loose financial conditions in the world's largest reserve currency country, the USA.

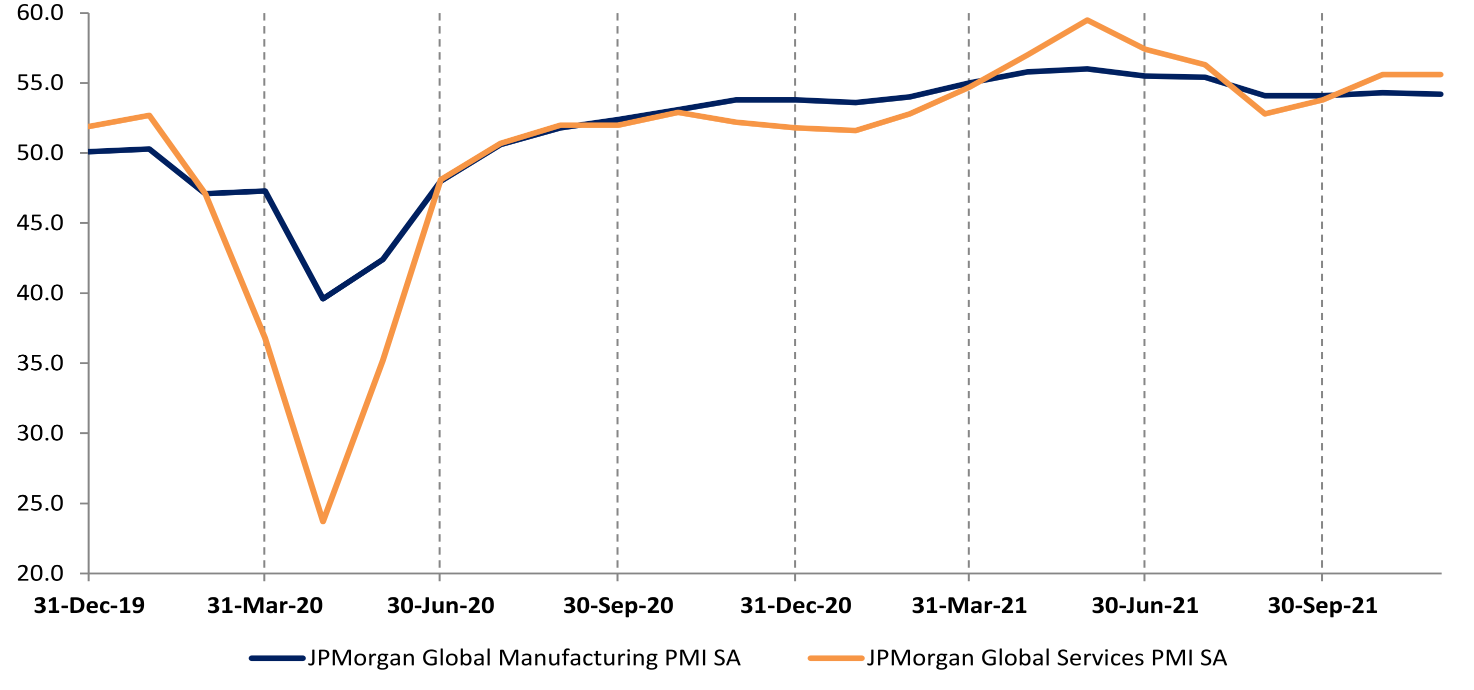
While the macro backdrop has proven supportive of risk markets over the course of the 2021 calendar year, a close examination shows that starting around the middle of June 2021 the backdrop has turned increasingly challenging owing to rising inflation concerns. Such concerns have fueled expectations of a more aggressive FED policy stance in 2022. In turn, such expectations have been validated by the FOMC at the recent 15th December FOMC meeting at which the median FED dot plot signaled three rate hikes for 2022 followed by another three rate hikes for 2023. Figure 5 illustrates the sustained rise in 3-year US Treasury yields that began in June. Such shift in investor expectations and market rate environment has manifested itself in the moderate tightening of financial conditions these past several months, shown in Figure 4.

Figure 2. Global Vaccination Program Advances Steadily over 2021



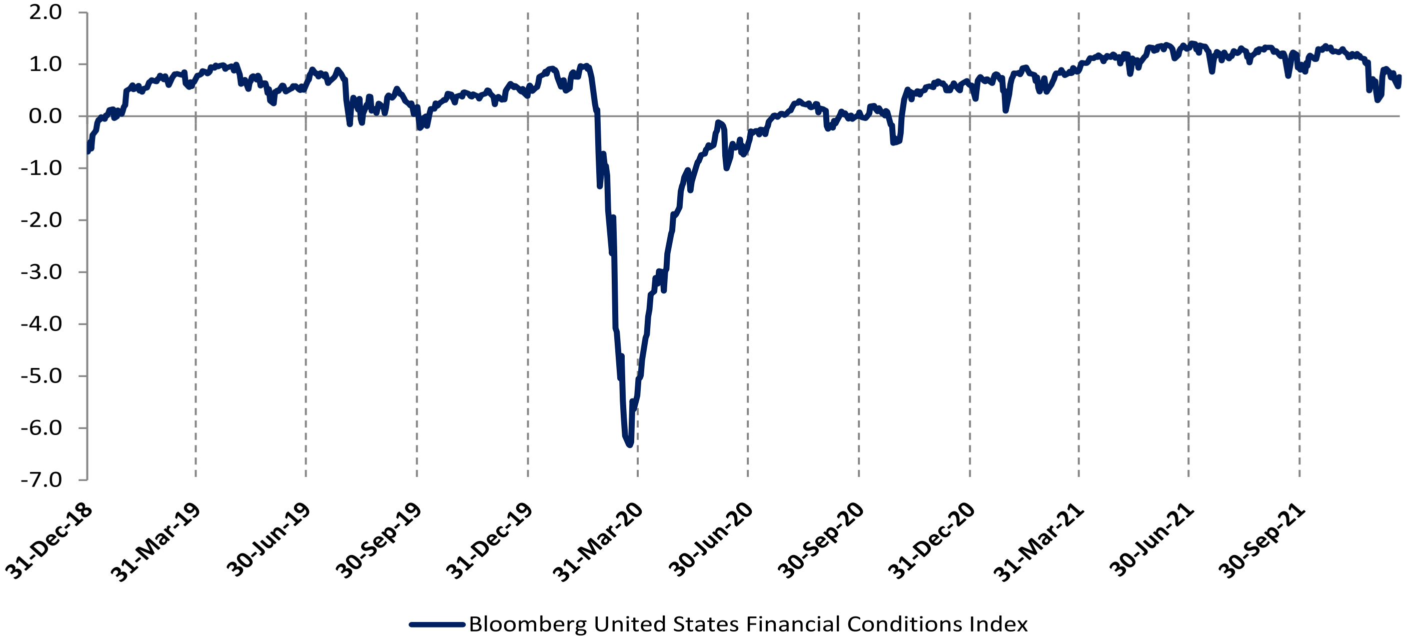
Source: Bloomberg

Figure 3. Global Economy Records Broad Recovery in 2021, across both Goods and Service Sectors



Source: Markit

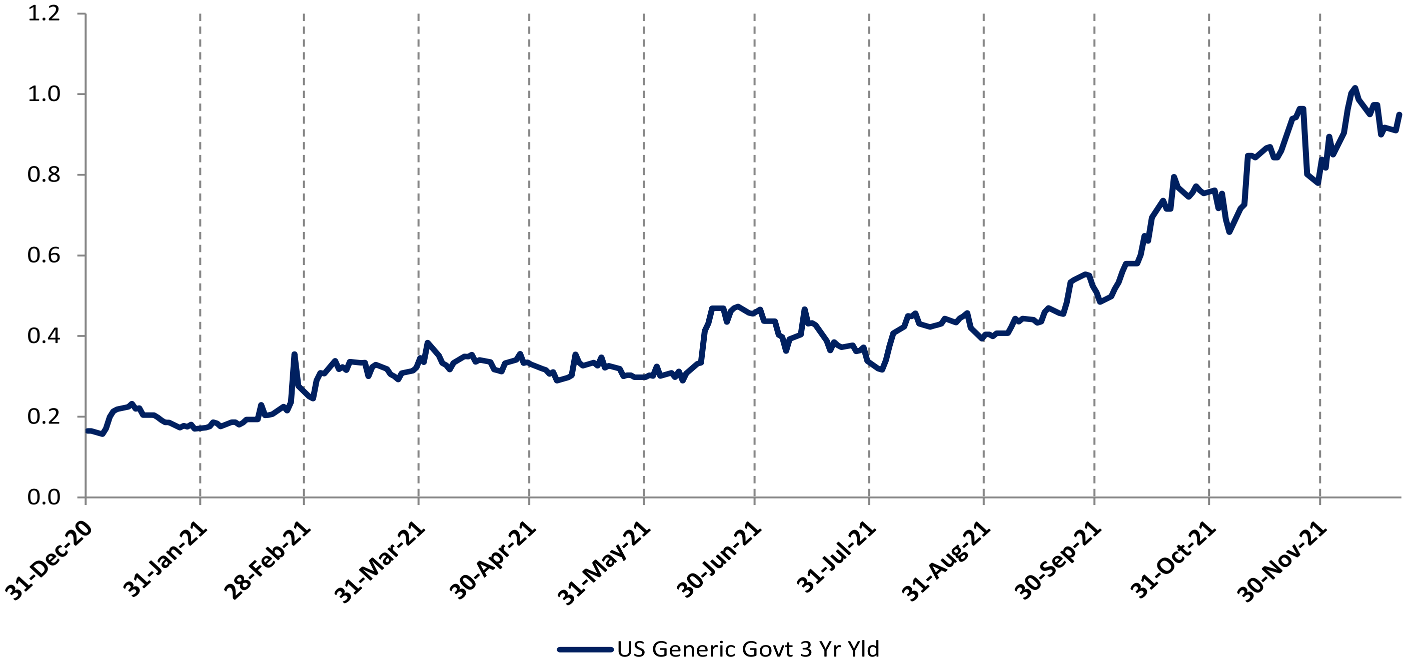
Figure 4. Loose Financial Conditions, a Supportive Factor to the 2021 Expansion



Source: Bloomberg

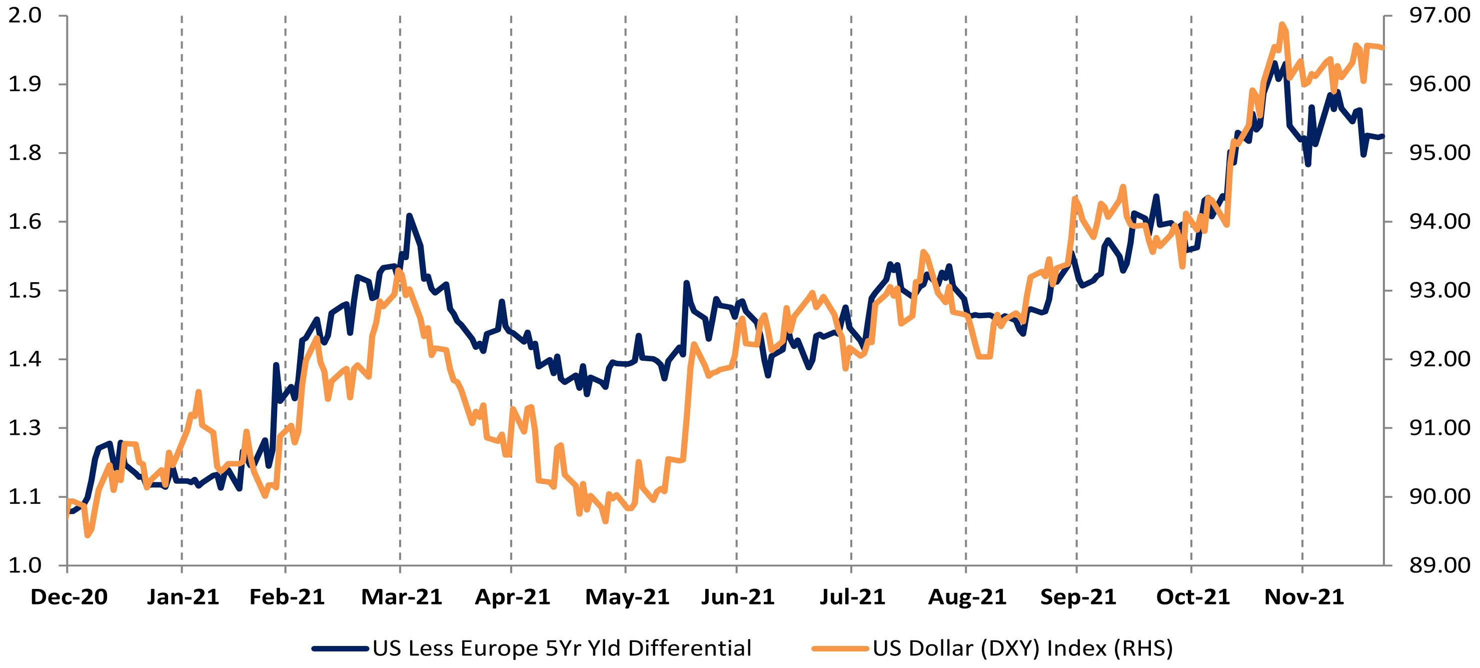
The inflation-led market rate rise environment since mid-year has impacted the front end of the US rate curve disproportionately versus European and Japanese peers' owing to the US economy's considerably smaller output gap. The resulting widening between US and European intermediate-term bond yields since then has brought about a stronger US$ period – itself a financial tightening development at a global level. Figure 6 illustrates such shift in intra-year dynamics between US Treasury-German Bund 5-year yield differentials and the US Dollar index.

Figure 5. Rising Inflation Concerns around Mid-year Helped Fuel Sustained Rise in Intermediate-term Yields



Source: Bloomberg

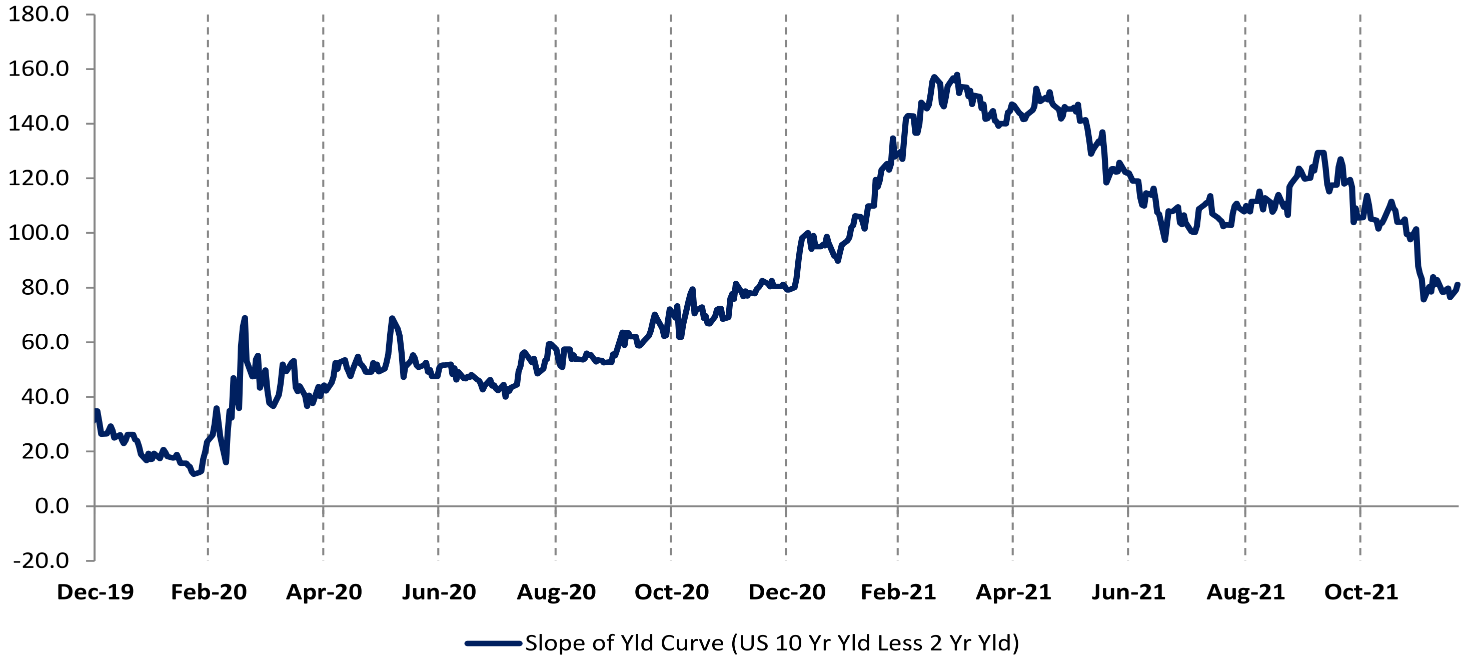
Figure 6. Mid-year Inflation-led Widening US-Eurozone Rate Differentials Trigger US Dollar Strength



Source: Bloomberg & Glovista Calculations

As a result of the dynamics noted above, the considerable rise in US rates has led to a recent tightening of US financial conditions, reinforced by the US Dollar strength. In the process, the US yield curve has been flattening considerably over the past several months, not yet inverting, with long-term Treasury yields having peaked in March of this year (Figure 7). As a result, any additional future tightening guidance by the US FED is likely to fuel heightened investor expectations of a policy mistake that could result in higher odds of recession.

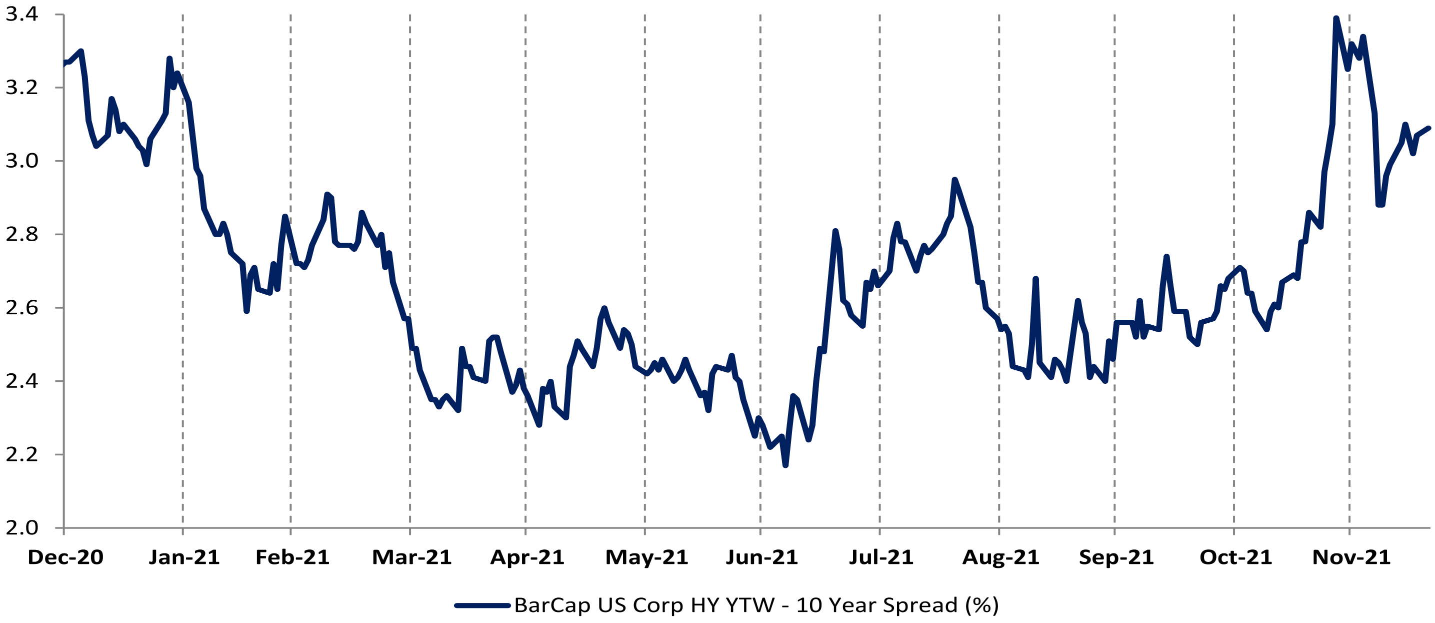
Figure 7. US Yield Curve Flattens as 2022 and 2023 FED Rate Hikes are Discounted



Source: Bloomberg & Glovista Calculations

The tightening of financial conditions has helped fuel a recent widening of credit spreads since the mid-June period. Figure 8 illustrates the sustained widening of US high yield spreads versus comparable Treasuries.

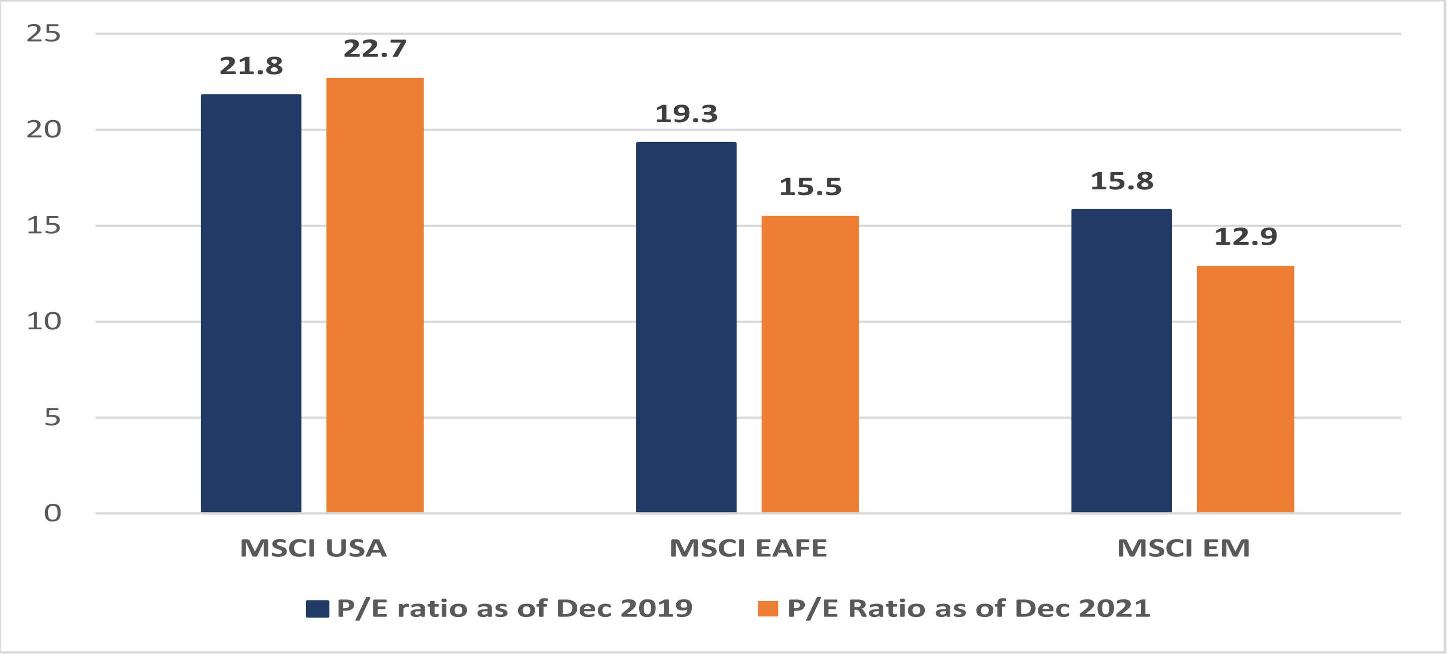
Figure 8. Credit Spreads Widen Steadily from Mid-June Low Levels



Source: Bloomberg

Against such macro backdrop, a number of market dynamics have unfolded during 2021, some of which we expect to be reinforced in 2022. First, within global equities, US equities have outperformed non-US peers, both developed and emerging markets. The dominant drivers underlying such return outperformance are given by the strengthening US Dollar and US equities' considerable relative multiple expansion versus non-US peers (Figure 9).

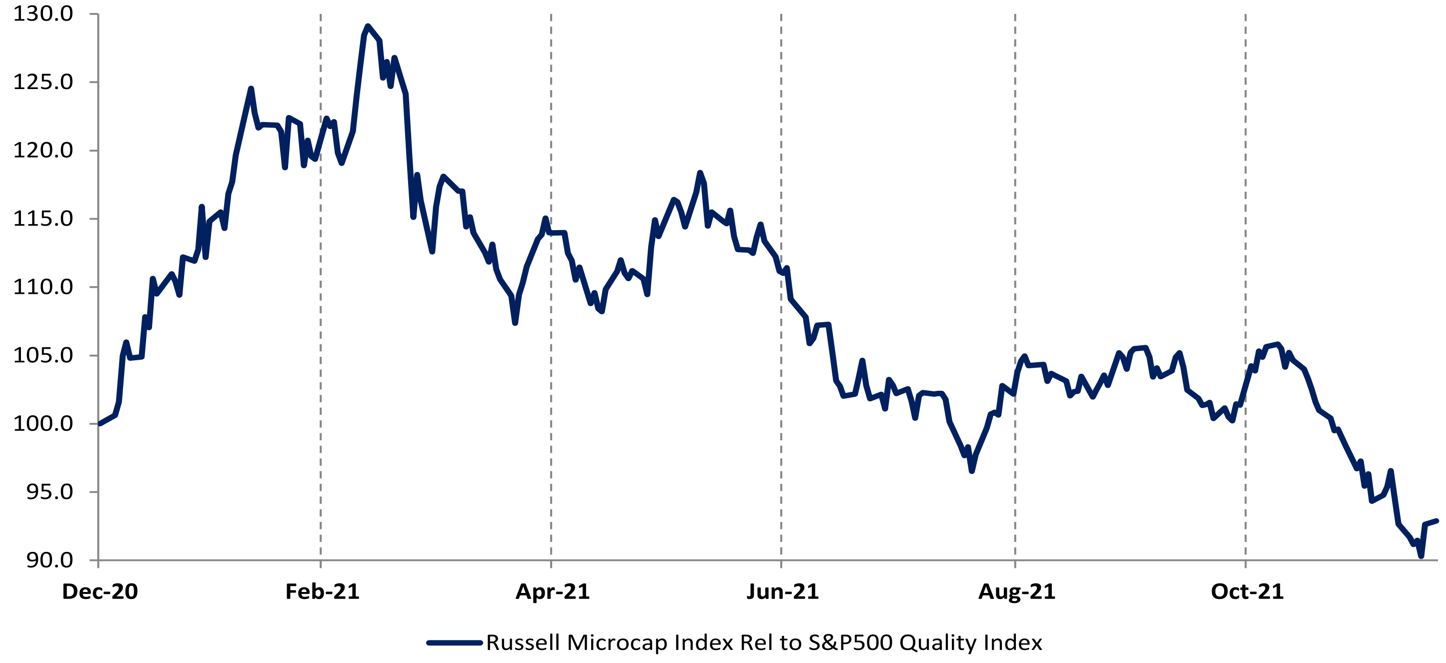
Figure 9. US Stocks Outperform International Peers in 2021, driven by US$ Strength and Relative Multiple Expansion. (Chart: Comparison of Current Trailing P/E Ratio to Pre-pandemic Levels)



Source: Bloomberg & Glovista Calculations

Second, as financial conditions reached their peak loosening levels early in 2021 relative return performance between low quality and high-quality stocks reached a corresponding climax (Figure 10). Figure 10 captures such dynamic with a comparison between US micro-cap stocks (as proxy for low quality) and US large cap quality benchmarks. Many investors may recall the late first quarter period of 2021 as one in which much market chatter was dominated by so-called meme stocks.

Figure 10. Low Quality Stocks Reach Maximum Overbought Levels versus High Quality Peers early in 2021, Prior to Peak Loose Financial Conditions



Source: Bloomberg & Glovista Calculations

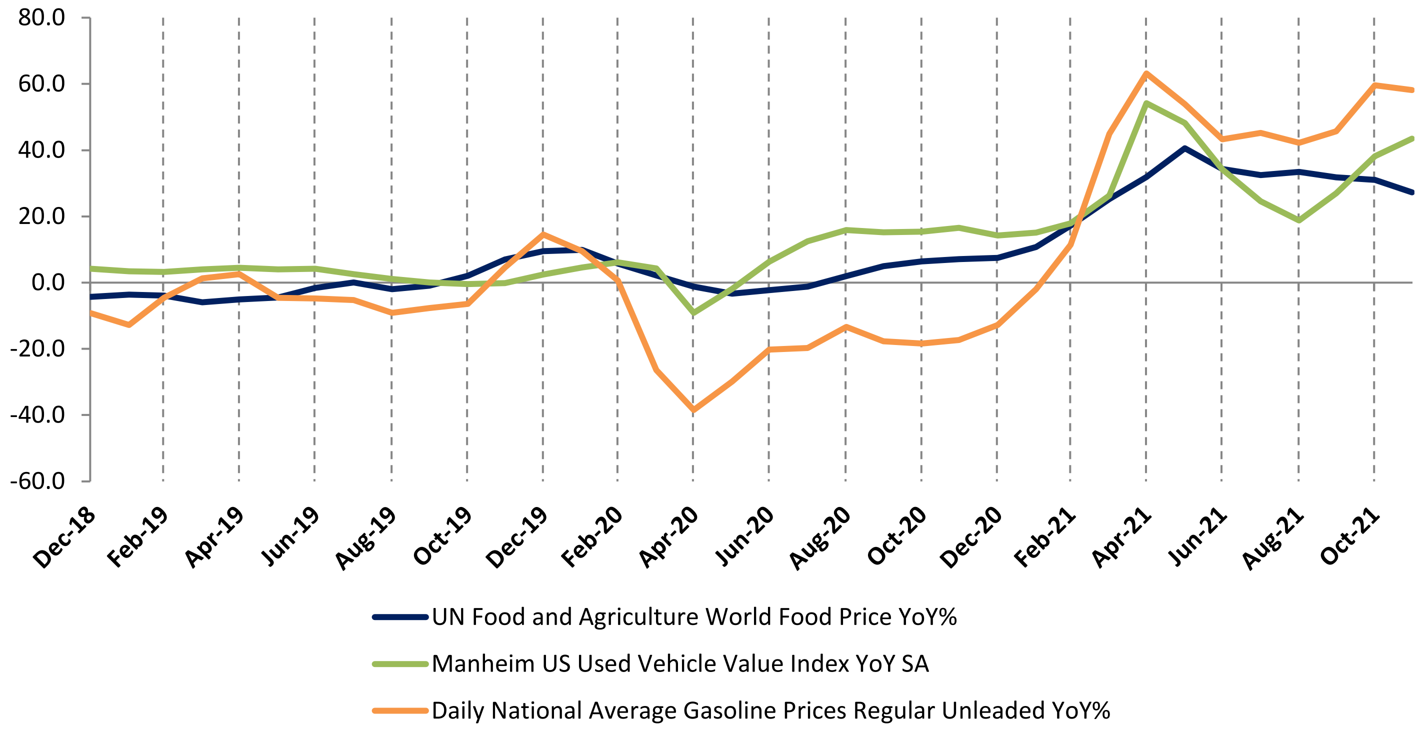
2022 Outlook: Continued Expansion Conditioned by Policy Risks tied to Inflation Concerns; Glovista Sustains High Quality, Value Tilts; US$ Likely to Weaken by Mid 2022

As we look ahead to 2022, we expect the global expansion to extend further as the constraining effects of the pandemic over aggregate demand continue to wane despite the ongoing succession of new virus strains.

First, the policy outlook remains constructive for several of the world's major regions, especially Europe, China and much of the rest of the emerging market economies where financial conditions are likely to loosen (China and a number of other large emerging market economies) and where fiscal conditions will be supportive (e.g. Eurozone). Likewise, continued crude price strength will be supportive of high consumption propensity economies in the Middle East, with favorable feedback effects on the Eurozone and North Asia.

Second, courtesy of the pandemic's restrictive effects on aggregate demand, household balance sheets are strong in much of the developed world and while financial conditions are likely to tighten further in the US (where output gap is much smaller than in Europe and Asia) we believe much of the future tightening is already discounted in the interest rate curve. The principal risk conditioning the outlook is that of a US Fed policy mistake in the form of over-tightening. Such risk considerations partly conditions our portfolio strategy for 2022 discussed further below.

Figure 11. Over the course of 2022, Year-on-Year Inflation Momentum Likely to Decline for Basic Staples of Household Consumption Baskets



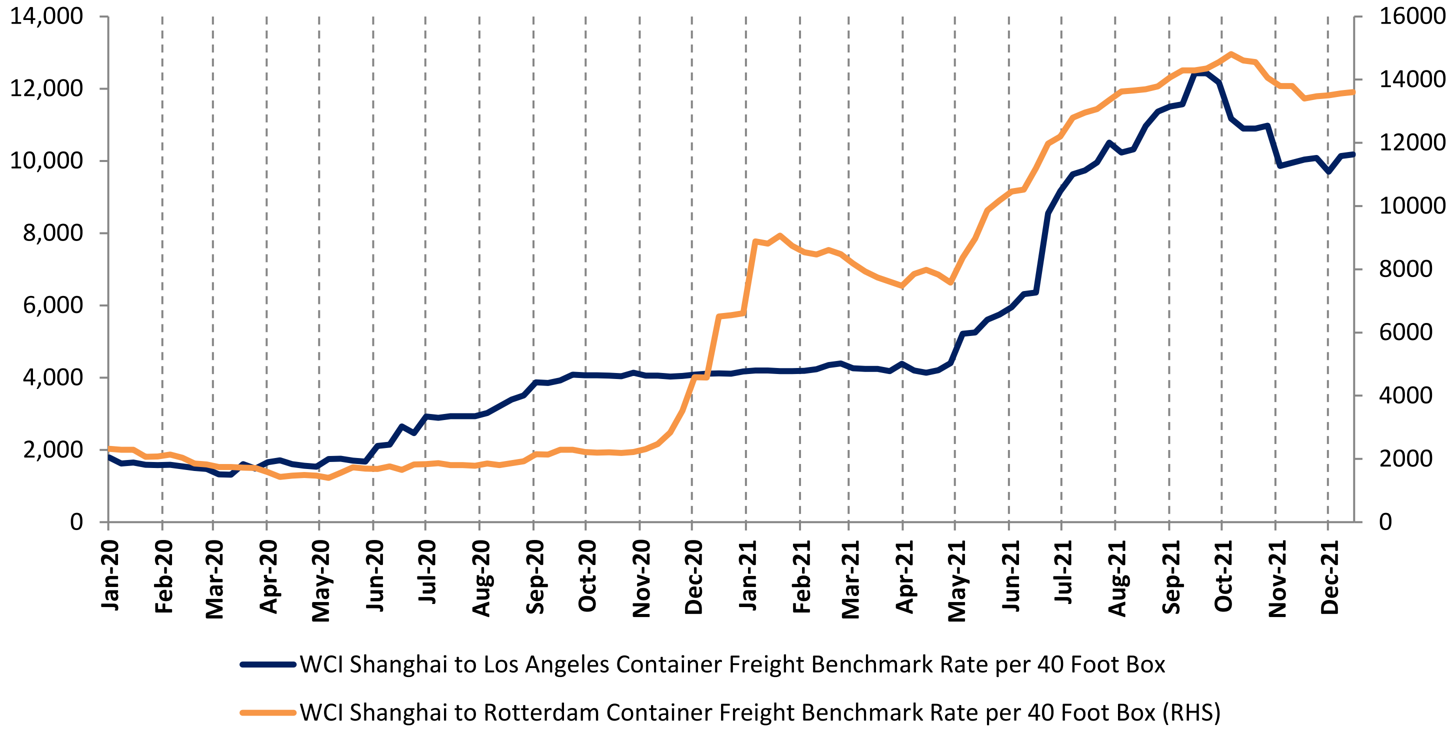
Source: Bloomberg, Manheim Auctions, United Nations, American Automobile Association and Glovista Calculations

Third, we foresee a sequential year-on-year decline in basic goods price inflation (e.g. energy and food) as supportive base year effects kick in. For example, Figure 11 highlights the ongoing decline in year-on-year inflation for basic staples in households' baskets, including gasoline, food and autos. Besides the ongoing deceleration in goods inflation, the extent of supply chain disruptions appears to be on the decline, as evidenced by peaking freight cost inflation (Figure 12). In that regard, lower income group's real household incomes are likely to strengthen over the course of the year, a period by when medium-term inflation concerns should have waned considerably from current levels. More importantly, despite the projected path of policy rate hikes in the US, forward inflation adjusted interest rate levels are likely to remain exceedingly low by historical standards. Such consideration lends further visibility to the future course of the global economic expansion.

Against a constructive 2022 activity outlook, constrained by an imminent start of a new US policy rate hike cycle as well as lingering inflation concerns, Glovista sustains overweight tilts to high quality and value factors both in equities and fixed income. In the currency domain, we view the protracted inflation effects from the pandemic to result in continued US Dollar strength early in 2022 to be followed by a resumption of US Dollar weakness by the middle of next year once output gaps in the rest of the world close further, supported by narrowing vaccination gaps between the US and the rest of the world.

Within global equities, at the regional level, we continue to favor overweight allocations to value sectors in the US along with mega-cap information technology stocks despite their strong 2021 year-to-date performance. In addition, we favor overweight tilts to value-oriented emerging market countries, discussed further in the emerging markets section. We also favor overweight allocations to core Eurozone markets and Japan. Within fixed income, we reaffirm overweight allocations to intermediate-duration high grade corporates. In the commodities space, we continue to favor tactical overweight exposure to precious metals on portfolio risk considerations and given our expectation of continued negative real interest rates.

Figure 12. Extent of Supply Chain Disruption Projected to Alleviate Further in 2022



Source: Drewry World Container Index

Of course, no outlook is bereft of risks. In that regard, we identify the following as the principal downside risk factors conditioning the 2022 outlook: upside inflation risks; US Fed policy mistake in the form of over-tightening, fueling yield curve inversion (especially in the 10s 2s), triggering recession concerns and a sharp market correction, and; geopolitical risks (e.g. Russia, China, North Korea and Iran).

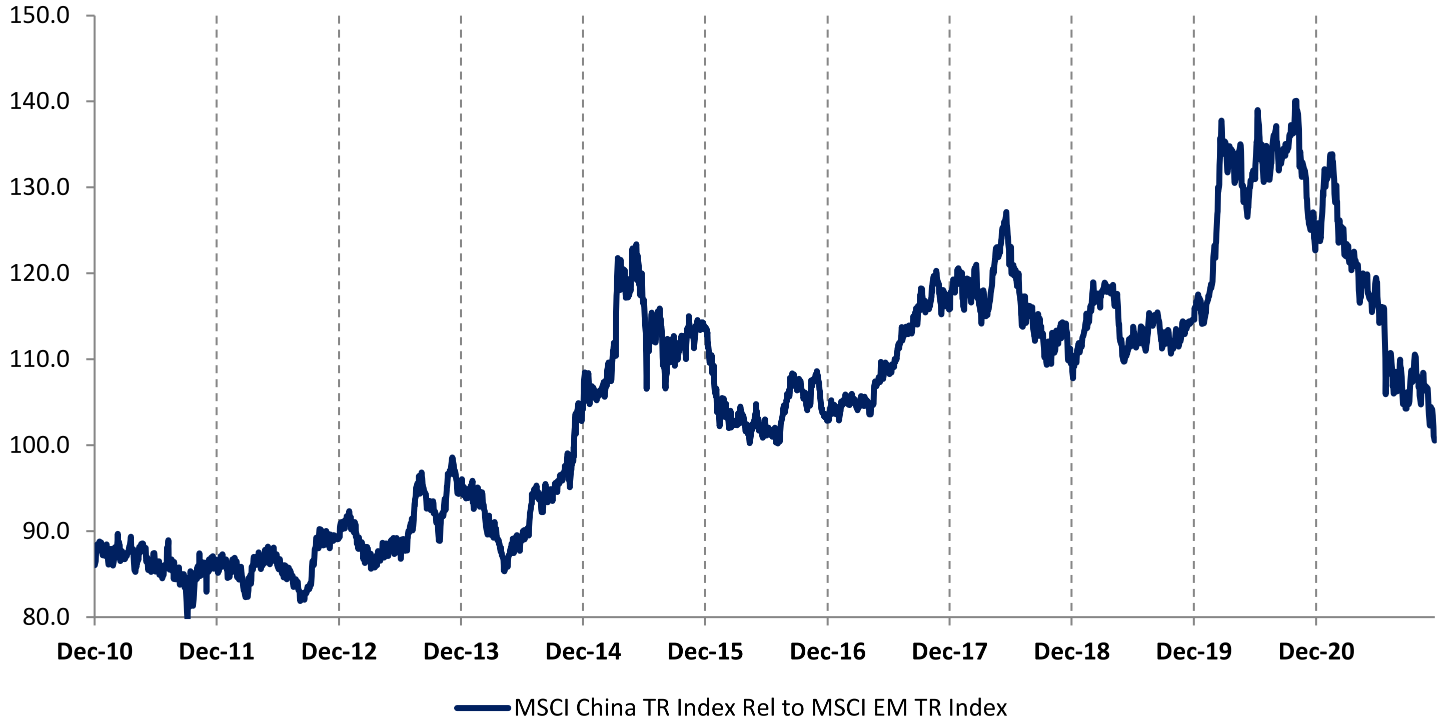
Emerging Market Perspectives

In 2022, EM ex-China Likely to Extend Robust Multi-year Outperformance of EAFE Peers on Valuation, Growth and Currency Factors; Chinese Stocks Likely to Outperform EM Peers on Re-rating and Growth; Glovista Favors Value Tilt

In 2021, emerging market equities have underperformed both EAFE and US peers, by 12.97% and 27.20% respectively as of 20th December 2021, on the back of several dynamics likely to reverse themselves in 2022. Such dynamics include the following:

- ***China Regulatory Developments***: Almost unprecedented underperformance by Chinese equities, during the year, following a series of drastic regulatory measures adversely impacting a number of the largest capitalization stocks in the MSCI China benchmark (e.g. Tencent, Alibaba, Meituan). Other industries have also been impacted, including the educational services, ride hailing apps, real estate and casinos. Such regulatory measures were justified by the Chinese government on the basis of 'common prosperity'. The exceedingly large order of magnitude of such underperformance is illustrated in Figure 13, a development that adversely impacted the overall EM benchmark's performance in 2021 on account of China's large weighting in the benchmark hovering at close to 38.9% at the beginning of 2021. As we look ahead to 2022, we believe the valuations for select Chinese technology and consumer stocks are attractive and should support strong performance as policy uncertainty subsides. Moreover, China's likely re-rating in 2022 should be further boosted by policy easing to support growth beginning with the recent cut in the banking system's reserve requirement ratio levels as well as 1-year loan prime rate;

Figure 13. In 2021 (as of December 20th 2021), Chinese Stocks Underperformed MSCI EM Index by 18.67%, the most since 2010.

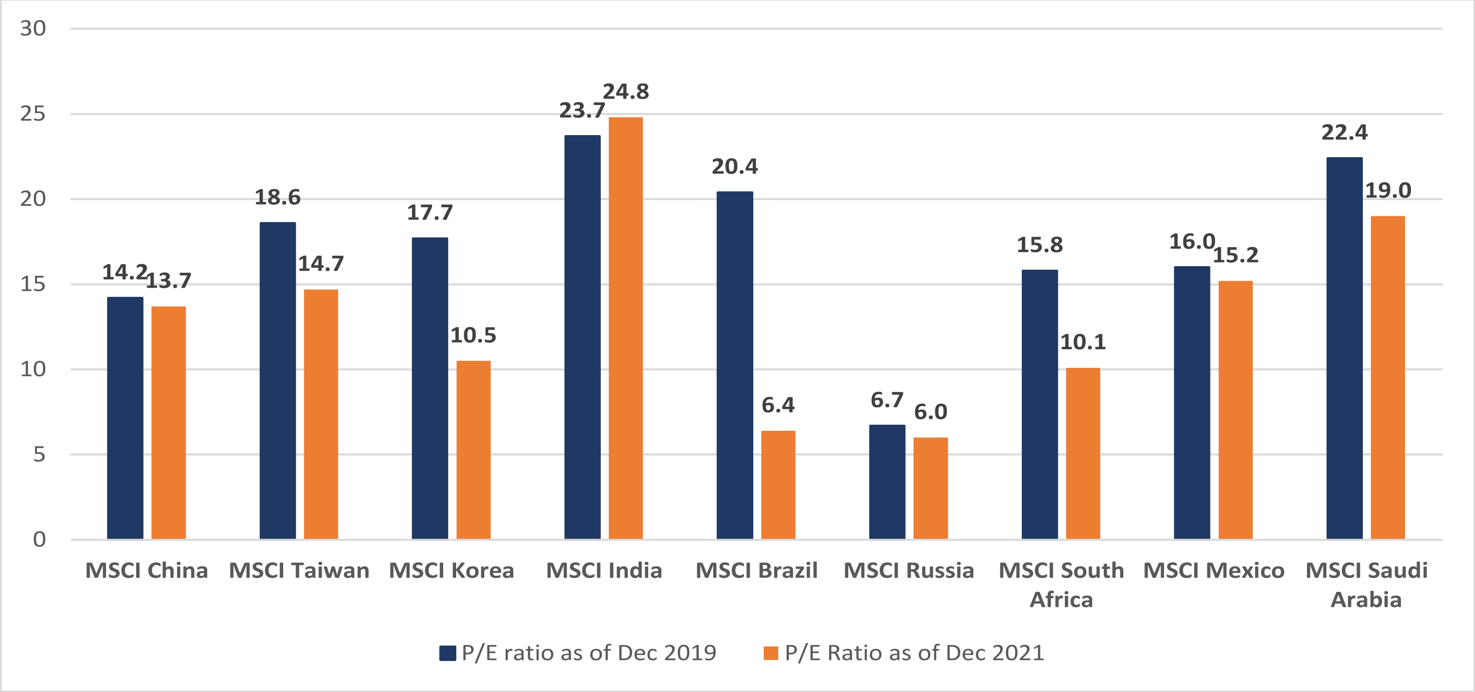


Source: MSCI, Bloomberg and Glovista Calculations

- ***US$ Strength:*** In 2021, International equities' US$ total return performance lagged US peers on account of: (a) the currency factor, as the US Dollar recorded sustained strength over the second half of the year (a dynamic discussed above) and (b) relative valuation multiple de-rating versus US peers, partly on the back of Chinese regulatory developments that unfolded over the course of 2021. As we look ahead, with the Fed scheduled to initiate its first policy rate hike by mid 2022, the weight of market history strongly suggests the US Dollar is likely to top out by then. Consequently, we believe in 2022 the currency factor is likely to turn from a headwind to a tailwind for international equities' relative performance versus US peers.

- ***Diverging Liquidity Conditions:*** In 2021, while liquidity conditions remained abundant and expansive in the developed world (e.g. USA and Europe), the opposite was true for a large number of emerging market economies where multiple policy rate hikes were implemented throughout the course of the year, including Brazil, Russia, Chile, Poland and Mexico. Such activist policy stance led to equity valuation multiple compression across a number of large emerging market indices. Figure 14 summarizes the changes in valuation multiples across major emerging market country indices' relative to pre-pandemic levels. As we look ahead at 2022, we foresee a reversal of such dynamic with the US Dollar likely to top out over the next several months, a dynamic that would conform to historical norm for US rate hike cycles. Table 2 summarizes the magnitude of policy rate hikes across a number of major EM economies along with prevailing real short-term policy rate levels as compared to those in the US, Europe and Japan.

Figure 14. Changes in Valuation Multiple (Trailing P/E Ratio) across Major Emerging Market Countries over the Pandemic period



Source: MSCI, Bloomberg and Glovista Calculations

Table 2. Selection of Emerging Market Central Banks' Policy Rate Hike Actions in 2021

				Quantum of		
		Weight in MSCI		Rate Hikes in		
	Country	EM Index	Policy Rate	2021	Core CPI YoY	Real Yield
1	USA	NA	0.125%	0.00%	4.90%	-4.775%
2	Euro Area	NA	0.0%	0.00%	2.60%	-2.600%
3	Japan	NA	-0.10%	0.00%	-0.70%	0.600%
4	UK	NA	0.25%	0.15%	4.00%	-3.750%
5	China	33.50%	3.80%	-0.05%	1.20%	2.600%
6	Taiwan	15.70%	1.125%	0.00%	1.49%	-0.365%
7	South Korea	12.80%	1.00%	0.50%	2.30%	-1.300%
8	India	12.30%	4.00%	0.0%	4.91%	-0.910%
9	Brazil	3.80%	9.25%	7.25%	7.56%	1.690%
10	Russia	3.70%	8.50%	4.25%	8.71%	-0.210%
11	South Africa	3.00%	3.75%	0.25%	3.30%	0.450%
12	Mexico	1.90%	5.50%	1.25%	5.67%	-0.170%
13	Thailand	1.60%	0.50%	0.00%	0.29%	0.210%
14	Indonesia	1.50%	3.50%	-0.25%	1.44%	2.060%
15	Malaysia	1.30%	1.75%	0.00%	0.70%	1.050%
16	Philippines	0.70%	2.00%	0.00%	3.30%	-1.300%
17	Poland	0.70%	1.75%	1.65%	4.70%	-2.950%
18	Chile	0.40%	4.00%	3.50%	5.80%	-1.800%

*CPI data for India is headline CPI YoY

Source: MSCI, Bloomberg and Glovista Calculations

In 2022, the Glovista investment team reaffirms overweight tilts to value-oriented emerging market countries as well as China. The primary basis underlying such portfolio stance is given by our expectation of a moderate normalization in real interest rates and increased global economic reopening in 2022 as a more definitive victory over the pandemic is reached. We believe the most alpha from such tilts is likely to be generated after the conclusion of winter in the northern hemisphere and victory over the Omicron strain.

Of course, the outlook is subject to a number of risks, including: geopolitical (e.g. Iran, Russia, China, North Korea), political developments (presidential elections in Brazil), policy (overtightening by the Fed), inflation acceleration beyond current expectations and Covid's protracted relevance.

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