Economic and Market Outlook 2022:

Back to basics

Market Strategy and Macroeconomics
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Overview

Societies have shown resolve and ingenuity in adapting to the pandemic. Medical science has astonished, while a remarkable combination of monetary and fiscal initiatives resurrected economies in a way and on a scale few thought possible. However, imbalances and opacity now prevail, meaning 2022 needs a shift in focus back to basics.

Global economic conditions are very robust, with growth anticipated to be well above trend in the coming year, albeit on a moderating trajectory. Welcome as this is, divergences among economies are clear and side effects of record stimulus, including notably higher inflation, are being felt. Consequently, the year ahead will be more nuanced. For policy makers it is no longer about doing all it takes to bolster activity, but rather focusing on mandates and moving towards a sustainable and productive expansion. For financial markets it will be less about abundant liquidity driving assets ever higher, and more about corporate fundamentals and valuations determining market moves. One thing seems clear, inflation and the policy response will define the year ahead.

The spike in inflation in most regions will likely start to retrace in the months ahead and it is worth remembering that inflation was seen until recently as wishful thinking and a high-class problem, should it arise. But arise it has. Base effects from the suppressed pricing environment at the depth of the pandemic will wear off, but the combination of supply shocks in manufacturing regions from lockdowns, and demand shocks from cash-rich consumers, will take longer to rebalance.

As a result, while trends should start to look better by the summer, inflation risks are to the upside. Central banks have not lost their inflation-fighting credentials, but, as we discuss in the US section, the Fed needs to up its game. The US economy is in full swing, with business investment surging, unemployment plunging and asset prices roaring higher. We see no need for asset purchases in this environment and expect the pace of taper to be expedited, with the first rate hike in place by mid year.

Inflation is also rising in the Eurozone, but dynamics here are less troubling. The ECB is expected to be on hold into 2023. Economic activity should be vigorous despite near-term risks associated with new restrictions on movement. The cyclical recovery has broadened and NextGenEU funding will add around 1% per year to growth. It won't be all plain sailing, however, with national elections in France and potentially in Italy offering some excitement.

Meanwhile, Asia is seeking change, with China pursuing 'Common Prosperity' and Japan 'New Capitalism'. For China the shift in direction comes with slowing growth, accentuated by rolling lockdowns amid a zero-Covid policy. So far, surging exports have offset softer domestic demand and credit tightening, but this will moderate, requiring additional stimulus. We suspect it will be targeted towards the greening of the economy and small- and medium-sized firms, rather than broad-based rate cuts as China orchestrates the transition to slower but more sustainable growth.

In Japan, PM Kishida aims to rejuvenate Japan's legacy of innovation and push 6G technology. While many countries are now easing back on fiscal support, Japan is opening up the spigots. Prospects for Japan are good as a potent combination of reopening, high savings, rising business investment, and fiscal funding kick in.

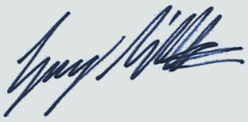
We explore Asia beyond the big two, seeing potential in both the ASEAN region and Australia. Manufacturing hubs are getting back into full swing, easing backlogs, and are likely to benefit from a restocking of inventories in western regions as consumption gradually eases. The Australian economy has been resilient to Covid restrictions, bolstered by domestic consumption that has been fuelled by high savings, and job growth which is set to continue. However, anaemic exports to China and a plateauing housing market should keep the RBA on hold throughout the year.

Latin America is expected to maintain its idiosyncratic nature, with politics and inflation perennial themes that are discussed in detail in that section. With prospects for Mexico improving, we see Brazil continuing to struggle under widening deficits and the aggressive policy tightening by the central bank. While rates and inflation should peak by mid-year, the potential for profligate fiscal initiatives in the run up to the presidential election pose a risk.

While it is back to basics for governments and policy makers, this also applies to investors as fundamentals matter once again. Elevated inflation, combined with above trend growth and rising deposit rates, is not good for bonds. A march higher in yields is likely to be bumpy given the risks and diverse policies being applied. Elevated debt levels will contain the move, but real returns are likely to be dismal. Credit markets offer some upside as companies have termed out debt and are benefitting from robust earnings, high interest coverage and minimal defaults. Spreads are likely to compress further, although volatility is expected to pick up as liquidity taps are turned off.

Equities are again our favoured asset class. Outside the US, valuations are fairly compelling and even US stocks don't look unreasonable in relation to both bond and credit valuations. The stage of the cycle and robust momentum can carry markets higher, and their nominal nature offers some protection from inflation, though we don't expect much in the way of multiple expansion. Emerging markets have had a woeful time, and while some are getting interesting with a lot of risk being priced in, they are not yet compelling, unlike the near term potential for Japanese and Eurozone stocks.

While Covid in its changing forms continues to blight the landscape and remains the greatest risk with the potential to undermine activity and sentiment, prospects for the coming year are good. Divergencies should be anticipated and a more nuanced world awaits as policy makers, companies and investors get back to basics.



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Contents

Global

Outlook

- Global growth is set to stay above trend despite policy tightening, as underlying growth drivers are strong
- Headline inflation should have peaked by the middle of 2022 partly reflecting more favourable base effects
- Policy tightening is expected to accelerate to temper strong demand and inflation

Implications

- Bond yields remain on a modest upward trajectory, with periods of higher volatility likely
- Credit to remain supported by search for yield, although spread returns should be volatile and lag those of equities
- Equities are not cheap but remain the favoured asset class, offering attractive relative value and good fundamentals

Risks

- Another round of lockdowns and supply chain disruptions amplify inflation and wage pressure
- A sharp and unexpected slowdown in global growth amid accelerated policy tightening
- A return to aggressive balance sheet releveraging negatively impacts credit amid tight spreads

Global growth is set to run well above trend despite accelerated policy tightening

Global growth is expected to stay above trend in 2022. While headwinds from monetary tightening will become more challenging, underlying growth drivers are strong and resilient to a modest tightening in financial conditions.

Households have built up a large stock of savings that will trickle into the global economy. The size of this effect is significant, with US households, which remain the consumers of the world, at the fore. While some savings have been used to pay back debt, US households have build up a sizable stock of excess cash and liquid deposits, to the tune of over 10% of GDP, a potential tailwind for consumer spending and the global economy. In addition, spending on consumer services continues to lag behind in many regions and there is potential for further upside, in particular when current Covid concerns begin to recede. Finally, business investment should also be brisk, reflecting strong final demand and pricing power, a lack of capacity among goods producers, favourable financial conditions, and the trend towards automation and digitisation.

Fiscal spending adds to the favourable growth outlook. While emergency support is being phased out, a stricter shift towards fiscal consolidation is not expected. Government spending on infrastructure and the greening of the economy will be significant in major markets. This follows a long period of insufficient government investment and has the potential to increase productivity and longer-term growth. The challenge will be to manage this in an environment with strong private sector demand and a lack of capacity, with positive spillover effects on aggregate demand and private sector capex likely to be smaller than in a weaker growth environment.

Inflation should peak in H1, but the outlook is vulnerable to new disruptions

Inflation will stay elevated into 2022 but upward pressure on prices should start to diminish in the first half of the year. Higher energy prices and Covid specific effects explain a significant part of the increase in annual CPI inflation over the past year. Unless energy prices rise further, this impact should wane in the first half of 2022.

The biggest surprise to inflation has, however, come from durable goods prices, including those of autos and electronics, where exceptionally strong demand has combined with a lack of supply to drive prices higher. Producer prices, particularly of energy, intermediate and investment goods, have also surged.

We suspect we are close to peak price pressure on some of these components, as goods demand starts to normalise and supply chain pressures ease. Even if conditions improve, however, there is little slack in the system, with businesses having depleted their inventories and unfilled orders elevated. This reduces resilience and creates vulnerability to new disruptions. We cannot rule out another round of Covid related restrictions, which could potentially ripple through global supply chains and labour markets, amplifying upward pressure on some prices. While the basecase around inflation remains fairly benign, near-term risk is to the upside.

Central bank actions anchor inflation, but this is no time for complacency

We were encouraged by the shift towards tighter monetary policy in 2021, as this confirmed that central banks remain focused on inflation. In emerging markets, rapidly rising rates are already a headwind to growth, offsetting expansionary fiscal policy and helping to contain inflation and FX pressures. In major developed markets (DM), central banks are lagging behind, though they have started to gradually taper asset purchases. Looking forward, we believe DM central banks need to step up stimulus removal, given significant upside surprises to inflation and continued strong demand, alongside still deeply negative real interest rates and highly favourable financial conditions. This is likely to be a dominant theme for the year, leaving policy expectations and rates highly sensitive to news on inflation and wages.

Global trade growth should rebound, helping to ease pressures

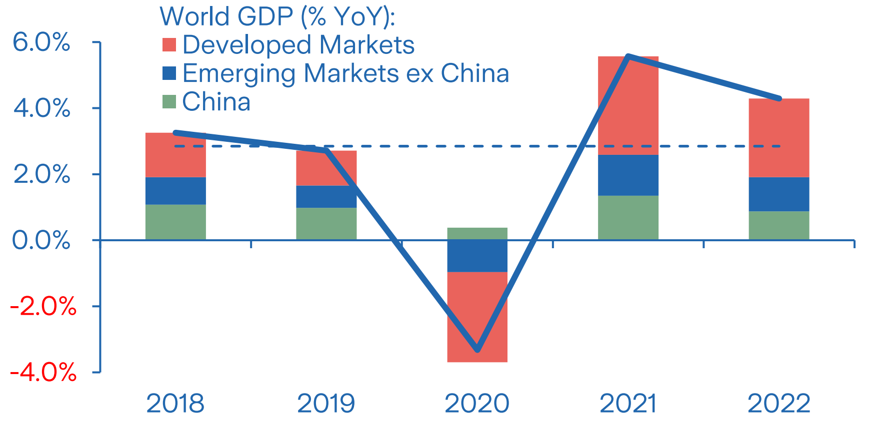
Global trade staged a very strong recovery after the Covid crisis, returning to it's pre-crisis level after only seven months, compared to almost 30 months after the global financial crisis. This reflected the sudden shift towards goods demand and huge support measures that boosted income and spending. More recently, global trade has stagnated. This partly reflects supply side challenges, such as lockdowns in Asian trading hubs and transportation bottlenecks. The easing of Asian lockdowns has already allowed supply of critical components to pick up and the backlog of unfilled orders in major exporting nations have declined from their peak in Q2. Reflecting this, global trade can reaccelerate into 2022, and this will be a critial condition for global growth to remain above trend.

Bond yields remain on an upward trajectory, albeit with volatility

As expected, global bond yields rose modestly through 2021, with periods of higher volatility as a reflection of virus and policy developments. We suspect this pattern will continue in 2022.

The move higher in yields in 2021 was predominantly driven by the shorter end of the curve, given accelarated policy tightening. Yields on longer maturity debt lagged behind, partly due to large central bank asset purchases and tight

Global growth expected to stay brisk



Source: ZIG

Note: Data for 21/22 are forecasts, Dotted line shows 2001-2019 Average

demand/supply, leading to flatter yield curves. Longer-term inflation expectations have also risen, but as this did not trigger sharp increases in long-term nominal bond yields, it allowed real yields to remain close to historical lows.

Looking forward, rates are likely to rise further, given strong demand and inflation. For monetary policy to become restrictive, real yields need to rise. We suspect this will happen through a combination of higher nominal yields and a stabilisation in inflation expectations. This will leave nominal yields on an upward trajectory, but with potential for significant volatility, reflecting both the Covid situation and the policy outlook. That said, we maintain our view that yields are capped and should stay benign compared to longer-term historical averages due to a combination of high debt and a search for yield environment.

In Europe, spreads on peripheral government bond yields are expected to widen somewhat over the course of 2022, mainly as a result of the ECB substantially reducing the size of its government bond purchase programme. However, macroeconomic fundamentals will remain supportive, limiting the extent of any spread widening.

Credit likely to stay supported but experience higher volatility

Credit markets are likely to stay supported in 2022 by solid fundamentals and a continued search for yield driven by low government bond yields and a lack of alternatives for liability driven investors. However, spread returns, while positive, would continue to lag those of equities while volatility is likely to be higher than what investors have become accustomed to over the last six quarters. Indeed, volatility has picked up already on concerns around Covid and monetary policy changes. Asset backed securities, US municipals and European covered bonds should also remain supported in 2022 while we retain our caution on European banks, as discussed in the regional sections.

Corporate leverage is likely to decline further over the coming quarters. Indeed high yield companies that used better financing conditions to improve liquidity profiles have seen a rapid decline in leverage. Interest coverage has been improving sharply especially in investment grade. We expect default rates to remain low, around 2% in high yield, and positive trends in credit ratings to continue with the so called ‘rising stars’ (high yield companies that achieve investment grade ratings) to drive outsized returns within portfolios.

While the gradual removal of accommodation by central banks in response to inflationary pressures will likely dent technicals, the level of liquidity is still expected to remain decent and supply should moderate given cash on balance sheets. Most importantly as a driver for demand, the proportional income increase from switching into credit from government bonds remains attractive. In US investment credit for example, this pickup still remains around the 80th percentile since the 1990s. Avoiding credit in fixed income portfolios is hence likely to prove costly for liability driven investors, especially in an environment with benign credit fundamentals and rising yields. We therefore expect positive albeit diminishing excess returns in credit amid higher volatility, with returns lagging those of equities.

Equities offer the greatest upside in a world of expensive assets and elevated inflation

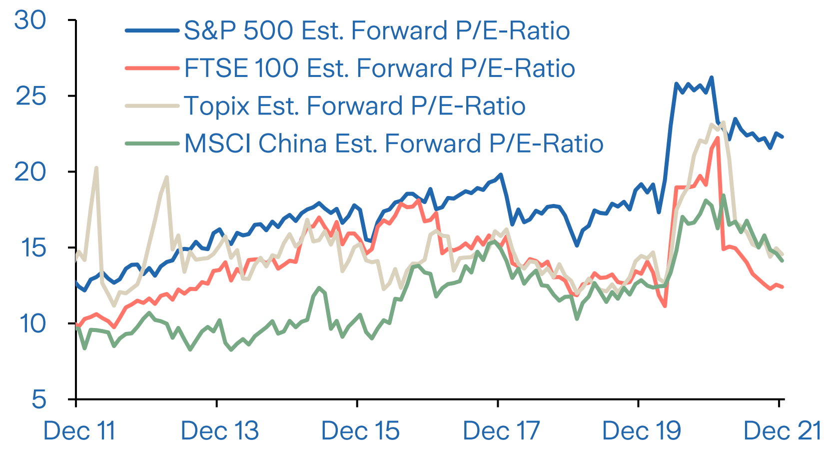
As was the case for the current year, equities is our favoured asset class for 2022, with high single, to low double-digit returns envisaged. We believe the economic cycle has a considerable way to run and this lends support to a robust earnings and margin environment as economies fully reopen. After a number of years of outflows, money has been gravitating back to equities and valuations of some markets are certainly rich. However, with substantial negative real yields in fixed income markets, stocks are attractive and generally offer some hedge against inflation.

Consequently, fund flows are expected to be supportive along with corporate activity. Balance sheets have been bolstered and afford a potent combination of capital spending, rising dividends, stock repurchases and M&A. While this can become a fairly toxic mix later in the cycle, currently it represents a tailwind for markets. That noted, stocks are unlikely to enjoy such a smooth up-track in the year ahead. Liquidity is no longer going to be the surging tide that lifts all boats and we expect more divergencies and idiosyncratic sectoral and regional moves as the year progresses.

With the heavyweight US market expected to continue its ascendency, this creates opportunities in other less expensive markets that have greater cyclical exposure. Both the Eurozone and Japan offer potential as their economies play catch-up and operating leverage kicks in. Emerging markets have become perennial underperformers and, after another poor year in 2021, we see them remaining under the cosh for some time yet. Chinese stocks have become unloved, with slower growth and a high regulatory burden now largely priced in, boding well for a recovery later in the year.

While the outlook for equities remains good, investors should beware of extrapolating the surging returns and low volatility we have become accustomed to in developed markets. There is upside ahead, but a more challenging and nuanced world should be anticipated.

Meaningful differences in regional equity valuations



Source: Bloomberg

US

Outlook

- The economy is expected to grow at a very robust pace in 2022, supported by strong consumer spending
- Inflation will remain elevated in the first half of the year as supply chain disruptions persist
- The Fed turns more hawkish and is poised to hike rates several times next year starting in Q2

Implications

- Bond yields are expected to rise further as growth remains strong and the Fed reduces its asset purchases
- Credit spread returns should be positive, albeit amid higher volatility and lag those of equities
- Solid earnings support equities, but high valuations and rising yields provide some headwind

Risks

- A significant flare-up of new Covid infections weigh on consumer spending and business investment
- Inflation rates rise more than expected, forcing the Fed to tighten policy faster than intended
- High inflation and monetary tightening lead to substantially higher bond yields, weighing on growth and equities

Economic growth is expected to remain significantly above potential in 2022

The US economy keeps powering ahead at a remarkable pace and although momentum is expected to slow down over the course of 2022, growth is likely to remain significantly above trend. Business sentiment remains at elevated levels with both the ISM Manufacturing and the ISM Services surveys hovering well above pre-crisis averages.

Backlogs of work rose to a record high in the fourth quarter as firms struggled to meet demand due to ongoing supply chain bottlenecks. New orders are signalling a continuation of solid demand and the restocking of low inventory levels will also support production in the coming year. Nevertheless, material shortages and supply chain delays will weigh on activity well into 2022. Mirroring these constraints, average input prices keep rising at a brisk pace, with firms facing higher costs due to supply issues, material shortages, higher transport fees and increasing wage bills.

Strong business activity will boost hiring and wage growth

Given the level of outstanding business, firms have stepped up their hiring efforts. However, filling open positions remains a major challenge as labour market bottlenecks persist. The NFIB small business survey's jobs-hard-to-fill measure has repeatedly reached new record highs in the past few months. The challenge of attracting new workers has also become visible in a marked pickup of wage growth. Amazon, Walmart, McDonald's, and CVS are just a few major employers that lifted wages meaningfully over the course of the year. Growth in average hourly earnings accelerated to 4.9% YoY in October. Other measures are also pointing at a marked pickup in wages. The broader employment cost index rose by 3.7% YoY in the third quarter, the steepest rise since 2004. Wages are expected to rise further in the coming months, particularly if labour market bottlenecks ease slower than expected.

Nevertheless, we don't think that these wage increases are the beginning of a broader wage-price spiral. The pandemic is unlikely to have fundamentally changed the structure of the labour market in the long run. Workers' currently strong bargaining power is expected to shrink once the employment situation normalises and the participation rate recovers.

A healthy employment situation is the basis for solid consumer spending

The employment situation is expected to improve further as the threat from the pandemic subsides and the economic expansion is increasingly broadening out into the service sector. Both initial as well as continuing jobless claims dropped to a post-recession low in the fourth quarter and are expected to keep falling in the coming months. Similarly, the unemployment rate and the broader underemployment rate will also fall further, though probably at a slower pace than over recent months. Although the participation rate has partially recovered since the depth of the recession, it remains well below pre-crisis levels. Rising employment paired with decent wage growth will provide healthy support to consumer spending in 2022. In addition, many households still have significant savings set aside during the lockdowns, fuelled by generous fiscal support.

While rising prices for some items do weigh on consumers' minds, household spending has been holding up reasonably well in the last few months. In the near term, consumer confidence and spending will crucially depend on the development of the pandemic. A significant reacceleration of new infections would weigh on households' activity and hold spending back.

Inflation rates are likely to remain elevated well into the next year

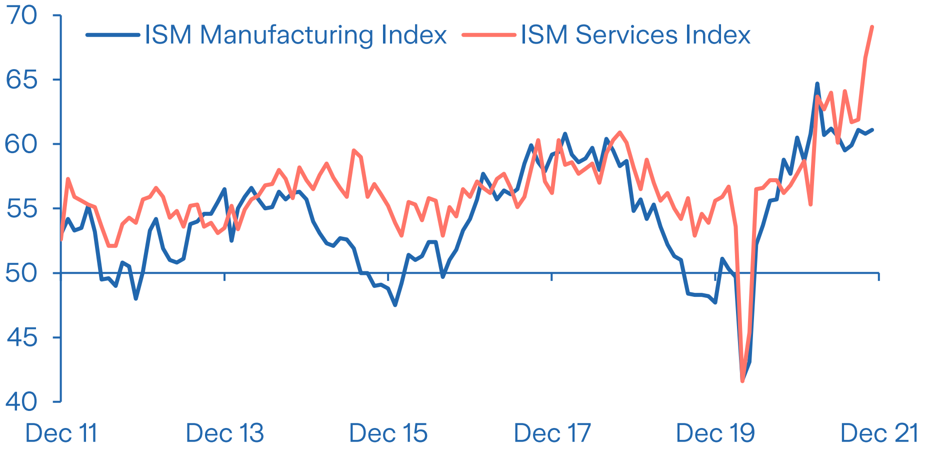
Rising prices for many goods and services have been an ongoing topic over the course of the year. Initially, the strong pickup in demand following the re-opening of the economy boosted prices in areas that have been particularly badly hit by the pandemic like airfares, hotels and dining out. Prices for both new and used cars soared as people regained their mobility but met limited supply, exacerbated by severe supply chain disruptions in many regions of the world. Many of these pandemic-induced price rises show signs of slowing down or are expected to fade in the coming months. Inflation rates will nevertheless remain elevated well into 2022.

House prices have risen by 20% on average compared to a year ago. That is the steepest rise in decades. While housing activity has cooled down in recent months with building permits, housing starts and new home sales receding from their peaks, higher house prices will impact shelter costs for some time to come. Rents tend to follow house price rises with a lag, so we have not yet seen the full impact on inflation and particularly on core inflation, where shelter costs are the biggest input factor .

The Fed is becoming more hawkish and is expected to start hiking rates in Q2 2022 following the end of the taper process

As oil prices reach the highest level since 2014, rising energy costs will add additional pressure on both firms and households. Though not the most significant factor in calculating inflation, price rises for energy and petrol tend to have a disproportionate impact on consumer sentiment. The overall pickup in inflation as well as the rise of both consumers' and market-based inflation expectations has led the Fed to take a more hawkish stance than just a few months ago. While not long ago the FOMC's rate projection basically signalled no change in the Fed's target rate until at least 2023 the latest forecasts now indicate that a majority

Business activity is booming



Source: Bloomberg

of Fed members expect rates to rise significantly in the coming two years, with a first rate hike now in 2022. Jerome Powell prepared markets well in advance regarding the Fed's intention to reduce its asset purchases with the goal of ending the process sooner than expected. Not surprisingly, the projected pace is conditional on the future development of the economy and could be adjusted accordingly.

Given solid growth and the strong housing market, with a steep rise in house prices, the Fed is somewhat behind the curve regarding tapering its asset purchases, in our view. Considering the robust growth environment and with inflation being significantly above target we expect the Fed to accelerate its tapering process in the coming months.

In addition to announcing the beginning of tapering, Powell also signalled a more relaxed stance towards the Fed's mandate of full employment, acknowledging that the participation rate is unlikely to rise back to pre-crisis levels anytime soon. The changed view on full employment brings forward expected rate hikes as the Fed will feel that it has reached both its mandates sooner.

Bond yields are expected to rise further as growth remains above potential

The potential for a policy mistake by the Fed is one of the major risks for our benign outlook. The Fed is worried about rising inflation and wants to keep its credibility by striving to achieve its average inflation target. But by tightening financial conditions too quickly the Fed would risk disrupting investment decisions and may provide unnecessary headwinds to financial markets. Longer-term yields are expected to rise further in 2022 as the expansion broadens out and the Fed reduces its asset purchases. With inflation expectations and break-evens rising to multi-year highs, real yields reached a record low last summer before recovering slightly. At a level of -1%, 10yr real yields are still at extraordinarily low levels, hardly reflecting the strong economic environment.

Credit to have positive excess returns but lag equities

US credit markets are likely to stay supported in 2022. We anticipate the primary drivers to be improving fundamentals and low default rates, which together with a search for yield should drive investors to the asset class.

That said, spread tightening in 2022 is unlikely to occur smoothly, with volatility in a changing monetary policy regime and rising Covid risks likely to cause increased investor angst, as was the case in recent weeks. Returns are hence expected to be positive, albeit lagging those of equities.

US corporate leverage has declined more sharply in high yield as leveraged companies retain their prudence and use favourable funding conditions to improve liability profiles. We expect this trend to continue. Consequently, default rates should remain low, at around 2%, with rising stars (companies whose ratings migrate from high yield to investment grade) expected to be investors' preferred picks. The search for yield seems set to continue, with the proportional income pickup in corporate bonds versus treasuries being around the 80th percentile since the 1990s for investment grade and 65th historical percentile for high yield, despite tight credit spreads. An overly aggressive Fed and Covid related developments remain key risks, demonstrated by the recent volatility, as does a shift in attitude by companies towards wholehearted embracing balance sheet releveraging.

Within sectors we believe both corporate and non-corporate sectors would remain supported. While US financials have solid capital levels, non-financial corporates should probably see an outperformance of BBBs and Bs. Asset backed securities (ABS) are expected to see some deterioration in delinquencies and defaults after the end of the deferral programs, albeit with limited losses to senior bonds. Despite low spreads, the short interest rate duration of ABS is a desirable feature in a rising yield environment. US municipals should see lower supply due to better financial positions of issuers given a stronger economy. Spreads would likely remain supported due to demand from wealthier individuals amid potentially higher tax rates. The expected infrastructure bill should also add a positive impact to the muni market. All in all, we expect a favourable environment for credit in 2022, albeit with higher volatility than that seen over the last few quarters.

Stock markets remain supported by low yields and strong earnings

Equities have rebounded with a vengeance following the massive drawdowns suffered during the pandemic-induced recession. The S&P 500 has more than doubled from the lows reached in 2020. With a performance of more than 20% since the beginning of the year as of November, the stock market is on track for another outstanding year. Strong corporate earnings have been an important driver for the stock market rally. Many investors underestimated the strength of the rebound and had to constantly raise their earnings expectations over the course of the year providing further fuel for equities. In the third quarter of 2021 companies on average managed to again beat expectations by more than usual. However, while still high, both earnings and sales surprises have moderated further and are moving closer to historical averages.

The underlying fundamentals for equities still look benign, particularly since there are few alternatives given historically low real yields and growth is expected to remain healthy in 2022. While we don't expect a significant further multiple expansion given the stage of the cycle, high single digit earnings growth can still deliver very decent returns. In addition, stock repurchases and M&A transactions could further support the market. Nevertheless, given high valuations, rising yields and tighter monetary policy, further stock market gains will be harder to achieve and setbacks are expected more frequently.

Surging corporate earnings are supporting the equity market

Source: Bloomberg

UK

Outlook

- Economic growth is expected to remain healthy leading to further improvements in the labour market
- Consumer spending will remain strong as wages rise and households dip into their excess savings
- Inflation is likely to peak in the first half of the year as global distortions continue to recede

Implications

- Bond yields are expected to rise further, supported by strong growth and elevated inflation rates
- Sterling credit to remain supported but likely to experience higher volatility
- UK equities are attractively valued and should be able to close the gap at least partially to other developed markets

Risks

- A significant reacceleration of new Covid cases weighs on consumer confidence and spending
- Brexit-related trade frictions with the EU flare up again, weighing on business sentiment and growth
- The Bank of England causes more market volatility while trying to quell stickier than expected inflation

The economy to grow at a healthy pace, but high input costs to weigh on activity

Business activity in the UK is showing signs of reaccelerating following the slowdown in the summer. The expansion is slightly unbalanced, however. While the service sector has picked up steam again, manufacturing keeps struggling with supply chain disruptions and severe shortages of staff and material. Unfortunately, supply chain issues are unlikely to disappear in the near term. Almost two thirds of UK manufacturers reported worsening supplier delivery times in October. Strong customer demand in combination with ongoing capacity constraints led to higher backlogs of work for eight months in a row.

On a positive note, continuously strong demand together with robust new orders led to a sharp rise in employment with a marked pickup in job creation. However, strong demand for workers has led to difficulties in filling open vacancies. As a result, firms face pressure from higher wages as well as rising input costs for materials and services. In fact, the latest increase in the average cost burden was the fastest since the PMI surveys began to measure the data back in January 1998.

Households are cautious, but excess savings will help to support consumer spending

Consumer spending has been a strong driver of the underlying recovery, though momentum has started to soften recently. Retail sales declined five months in a row from May to September 2021 – the longest such run since data began in 1988 – before rebounding in October. The weakening trend is also reflected in a marked fall in consumer confidence, weighed down by a steep drop in households' perception of their financial situation in a year's time.

Several headwinds weigh on consumers' minds and spending. Real disposable income is expected to fall after the end of the furlough program, with Universal Credit payments to be reduced by GBP 20 per week and living costs rising given higher inflation rates that are likely to last well into 2022.

Reflecting the cautious outlook, the savings rate of households remains above pre-crisis levels meaning that the pile of excess savings kept rising over the summer months. On a positive note, these savings will help to smooth consumption and could extend the period of above average growth. Though for this to happen consumer confidence needs to recover. For the time being, households prefer to pay down existing debt, a trend that could potentially run further if interest rates keep rising as we expect.

Consumers are also reluctant to borrow with consumer credit gross lending more than 5% below its 2019 average level in September. This partially reflects households' cautious outlook though reduced borrowing is also a result of the recent slump in car sales due to the ongoing supply chain disruptions.

The employment situation is expected to improve further as economic growth remains strong

A lot will depend on how the employment situation develops. Employment gains have been strong since the reopening of the economy and the unemployment rate has receded markedly from a peak of 5.2% in December 2020 to 4.3% in September. The flip side of the rapid decrease in the unemployment rate is the absence of a strong pickup in the labour supply.

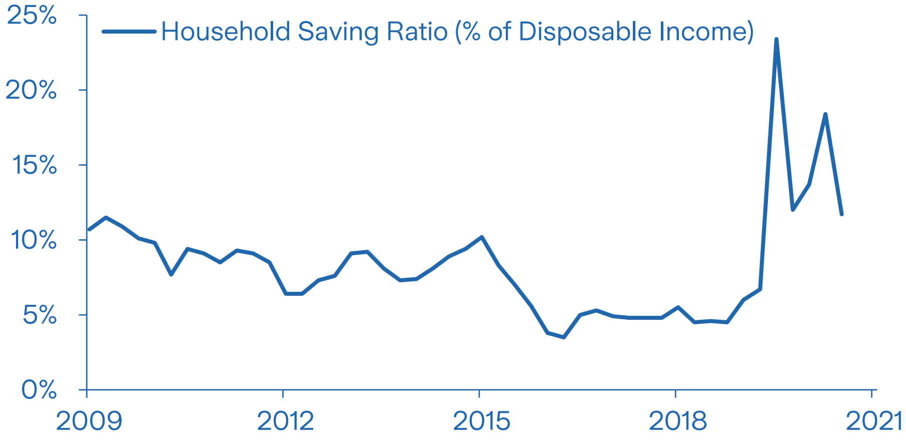
The participation rate is well below pre-pandemic levels and is not showing signs of a significant rebound in the near future. In particular, a substantial part of the lower participation rate was caused by older workers choosing to retire early. These workers are unlikely to return to the labour market in significant numbers. An additional drag on labour supply is coming from weaker growth of the working population, which must be at least partially attributed to Brexit. The pandemic is likely to have accelerated emigration of foreign-born UK residents given the difficult economic environment during the lockdown. Whether these workers are willing and able to return to the UK will depend on the future regulation of migration.

Despite a large number of workers leaving the furlough program in the past few months, vacancies have continued to rise. This indicates, that in addition to the overall reduction in the labour force, qualification mismatches make it even more difficult to fill open positions. Overall, labour market frictions and a strong demand for workers has pushed wages up. Growth in average weekly earnings accelerated to 8.8% YoY in June, the fastest in more than two decades, before slowing down to 5.8% in September. Higher wages will support consumer spending but will weigh on business margins and corporate earnings. Nevertheless, given firms' positive outlook and the expected positive growth environment, business spending and investment are expected to pick up.

Fewer fiscal headwinds

Based on the latest budget recently presented by Chancellor Sunak, the expected drag from fiscal policy will be less severe than initially thought. There is a continued commitment by the Chancellor to reduce the deficit and the debt ratio over the course of the current parliament. However, thanks to positive growth revisions by the Office for Budget Responsibility (OBR) Sunak was able to announce a discretionary policy loosening in 2022 and 2023 amounting to a little less than 1% of GDP. Discretionary spending with a direct impact on private households will be rather limited, however, including for example freezes on alcohol and fuel duty. Most of the fiscal loosening will benefit government departments.

Excess savings will help to support consumer spending



Source: Bloomberg

Taken together, the OBR revised down its forecast for overall borrowing in 2022/23 to GBP 83bn, from GBP 106.9bn in the March Budget. The latest policy announcements allow Chancellor Sunak to meet his target of a – slightly – falling debt-to-GDP ratio in 2024/25. Similarly, the current fiscal plan would result in a budget surplus in three years. However, this will depend on the relatively benign assumptions regarding growth and tax revenue becoming reality.

The Bank of England is sending contradictory signals and losing credibility

Bond yields rose over the summer months as the economic expansion broadened out. Rising inflation and a hawkish tilt by the Bank of England (BoE) have added further fuel for higher yields. Future projections regarding the BoE's rate path rose markedly over the past few weeks as several members of the Monetary Policy Committee stoked expectations about imminent steps to tighten monetary policy. In contradiction to these signals the BoE decided to stay on hold causing a violent repricing in financial markets. Yields on 10yr gilts lost almost a quarter of a percentage point in just two days while sterling lost more than 1.5% against the USD before stabilising.

We think that it would have been too early for the BoE to tighten policy at this stage, particularly given that the end of the furlough program's full impact on the labour market is not yet known. We expect the first rate hike either at the MPC meeting in December, or February. Should inflation rise faster and by more than expected, the BoE could always speed up the tightening process. However, by sending out highly contradictory signals the BoE has unnecessarily stirred the markets and lost credibility.

Inflation rates are expected to peak in the first half of the year while bond yields should rise further

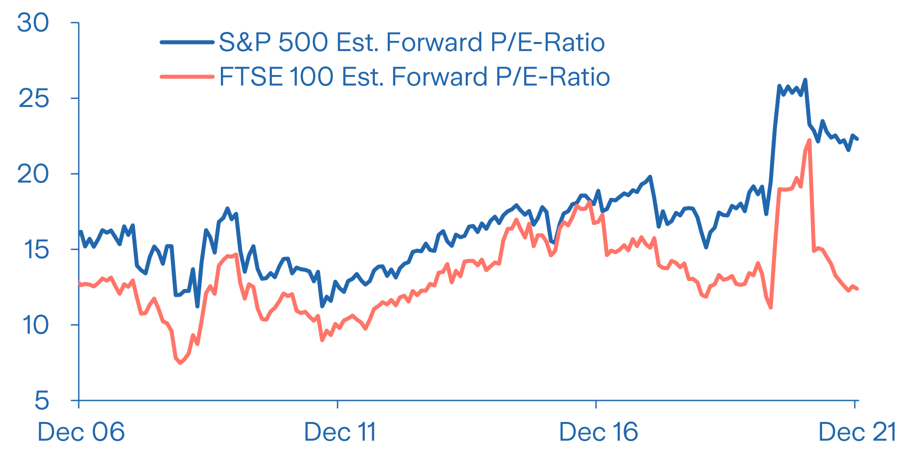
Bond yields are expected to resume their trend higher in 2022. Growth is likely to remain strong and although we expect inflation to fall back towards more normal levels in the second half of the year, the peak is still ahead of us. Domestically generated inflation remains subdued with rising energy prices and global supply chain disruptions having a major impact on the UK's price level.

Similar to what can be observed in other countries, very high inflation rates for used cars had a substantial impact on recent inflation rates. We expect the influence of these distortions to gradually recede over the course of the year. Similarly, service inflation should be contained as the current demand/supply-mismatch in the labour market is likely to dissolve in 2022.

Credit to stay supported but with higher volatility

Sterling credit is likely to remain supported, albeit amid higher volatility, in line with our view on global credit markets. Sterling credit has been rangebound this year but has recently outperformed the Eurozone credit market, with the latter softening after September. We believe that while upside in credit is not substantial, spreads should still hold in given the global search for yield that we expect should remain intact in 2022. UK ABS fundamentals remain healthy given the strong economic recovery and recent house price dynamics. Lenders have also remained disciplined for new loan origination and ABS structures remain conservative. While spread compression in ABS should be limited, we don't expect material spread widening. ABS should benefit from stronger investor demand if central banks start to tighten their monetary policy as most bonds are floating-rate notes.

British stocks show very attractive valuations



Source: Bloomberg

British stocks are lagging many of their peers but show very attractive valuations

Despite showing a decent performance, the UK stock market has lagged most of its developed market peers for the majority of the year. A high share of energy and mining companies as well as financial firms have not benefitted the FTSE 100 despite strong global growth, rising yields, and higher commodity prices. Investors' focus was predominantly on the US stock market with its higher share of large technology companies. Even attractive valuations have not been enough to lure global investors into British stocks in large numbers.

However, the valuation gap has now become substantial. The FTSE 100's forward price/earnings-ratio stands at about 12.5, which is low even with regard to pre-pandemic standards. On the other hand, the S&P 500 currently is valued at a forward PE ratio of almost 23 which is very rich. It is true that many trends that were accelerated by the pandemic have benefitted the US stock market. Nevertheless, with the global economy normalising further UK stocks offer attractive valuations and have the potential to catch up at least a part of their recent underperformance.

Eurozone

Outlook

- Another strong year overall expected for 2022
- Growth likely to dip early in the year due to various headwinds
- The economy will be resilient, with ongoing fiscal and monetary support and healthy household balance sheets

Implications

- Government bond yields to move gradually higher, but in fits and starts
- Credit should see positive returns but lag equities on a risk adjusted basis
- Corporate earnings and equities should experience a good year, albeit with more volatility

Risks

- Headwinds such as the slowdown in China, high energy prices and supply-chain disruptions take longer to dissipate
- Political events in France or Italy lead to an outcome that causes financial markets to react negatively
- Corporate insolvencies rise as government support schemes are withdrawn

Another year of above-trend growth

The extremely strong monetary and fiscal policy response to the Covid crisis as well as the rapid development of vaccines led to a "V-shaped" recovery in the Eurozone economy in 2021, with GDP almost back to its pre-Covid levels by Q3. Relative to the trend of where the economy would have been were it not for Covid, there is still some economic activity to be made up, but the rebound has been impressive.

The benefit of such a sharp rebound in activity is that it reduces the chances of economic scarring that can often happen when there is a deep recession with lingering effects. For example, workers who stay unemployed for a long time can gradually become de-skilled and/or de-motivated, while factory capacity that stands idle too long can eventually become obsolete. Fortunately, this is unlikely to be the case this time around given the strength of the recovery. Unemployment, for example, is falling sharply and we expect this trend to continue.

Fiscal stimulus will remain substantial

While the massive support from national governments such as furlough schemes and transfer payments to households is ending, there will still be an ongoing and significant fiscal stimulus over the next few years thanks to the NextGenEU initiative of up to one percentage point (pp) of GDP per annum. In some ways, the NextGenEU initiative can be thought as a second Marshall Plan for Europe, with the potential to radically transform the fabric of the Eurozone economy over the next few years and boost long-term growth.

Households to remain resilient

In addition, we expect households and companies will gradually pick up the baton of growth. Household savings remain well above average levels, suggesting a lot of potential pent-up demand, and with unemployment continuing to fall this should support consumer confidence and spending. Companies will have to invest more to keep pace with demand and to manage their own ESG (Environmental, Social and Governance) transformation.

The upshot is that the region is set for another strong year of growth in 2022 that should support risk assets in the region. However, there are some near-term obstacles to growth that will also need to be dealt with successfully first.

Some near-term headwinds to endure

Indeed, we expect Eurozone growth to moderate sharply around the turn of the year, but, crucially, still stay positive. Natural gas prices and inflation are surging while bottleneck issues remain in the manufacturing sector. A slowdown in China is likely to affect the demand for Eurozone exports to Asia, and Covid cases are picking up again in some Eurozone countries, notably Germany, resulting in renewed lockdowns and restrictions.

As a result, we expect growth will slow substantially early in 2022 from the blistering pace set in Q2 and Q3 2021 when the economy grew more than 2% QoQ in each quarter as economic activity resumed and winter lockdowns were eased. Nevertheless, we expect many of the headwinds mentioned above, such as spiking gas prices and increasing Covid cases, to dissipate by the end of the first quarter or at the latest by the first half of 2022, leading to a pickup in the pace of growth as the underlying resilience and policy support available for the economy becomes manifest.

Political events should be manageable

Admittedly, there is a busy political calendar for the region in 2022, which could be another source of volatility. The 'highlight' will be the French Presidential elections, scheduled over two rounds in April followed by parliamentary elections in June.

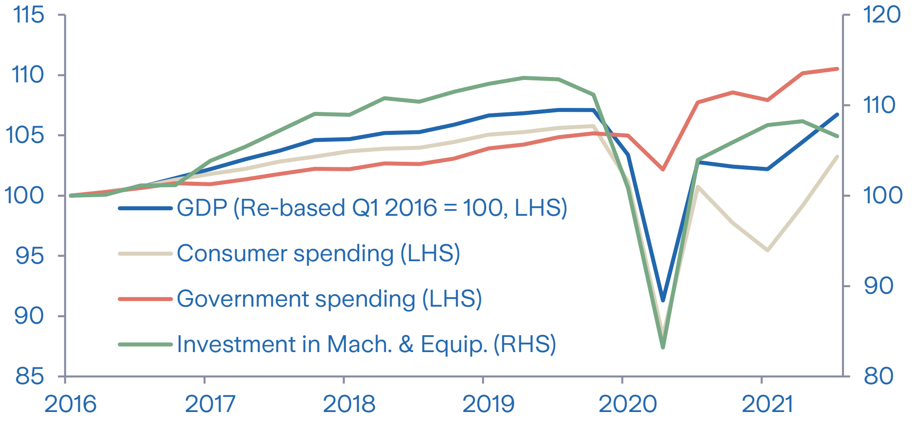
Much is currently being made of right-wing media personality and journalist Eric Zemmour's strong showing in the polls for the first round. However, the two-stage system of French presidential elections with only two candidates making it through to the second round, makes it hard for extremist candidates from either the left or right to ultimately make it to the Élysée Palace. It is highly likely that a more mainstream candidate, probably current incumbent Emmanuel Macron, will be elected President, reducing the chances of a severe upset to financial markets apart from maybe some temporary volatility in French equity and bond markets in the run-up to the elections.

President Draghi?

Another source of potential political and financial market volatility is in Italy, where it is possible that current Prime Minister and former ECB President, Mario Draghi, will be elected President (by the parliament) when the current President, Sergio Mattarella's, mandate ends in February. If Mario Draghi does become President, it is likely that new parliamentary elections will be called for the Spring of 2022, with a coalition government being formed at that time.

Investors would probably prefer that Draghi simply continue as Prime Minister for as long as possible, and this could still end up being the ultimate outcome if he decides not to run for President. Either way, the roll-out of the NextGenEU initiative in Italy is likely to continue. What's more, the accompanying reforms that are needed for ongoing disbursement of funds were already agreed upon with the European Commission when the Italian government presented its Recovery and Resilience Programme for approval in 2021.

The upshot is that while financial markets would probably react negatively in the near term to Mario Draghi moving on, preferring a technocrat of Mr Draghi's calibre at the helm and viewing anything else as a second best, V-shaped recovery in Eurozone economy led by government spending



Source: Bloomberg

the rolling out of the NextGenEU initiative will continue, whoever is in residence at the Chigi palace. Nevertheless, his departure and the announcement of fresh elections would probably see Italian bond spreads widen, but not to levels where this would call into question Italy's debt sustainability or its membership of the single currency area.

The ECB's communication headache

On the monetary side, the ECB will face a difficult task in 2022. Inflation is at multi-year highs and well above its 2% symmetric target. Nevertheless, we think the ECB is unlikely to raise interest rates in 2022 and will instead continue with asset purchases, albeit at a much reduced pace compared to 2021. We have some sympathy for the ECB's view that headline inflation is currently driven by some temporary factors that will fade over time. Indeed, currently almost half of inflation is due to high oil and gas prices.

However, we also think underlying inflation is gradually creeping higher in the region and that this will probably lead the ECB to raise interest rates eventually, but likely only in 2023. This would arguably be a good thing as it would provide an exit from negative interest rates, which we have long said are distortionary to the financial system and counterproductive.

Government bond yields and peripheral spreads to move higher in fits and starts

As the economy grows and investors focus on the ECB's potential next steps in monetary policy we expect core Eurozone government bond yields, such as those of Germany and France, as well as periphery yields, such as those of Italy and Spain, to move higher through the course of 2022, but probably in fits and start.

The ECB's communication around its monetary policy will be a challenge in 2022, with any potential missteps or lack of clarity likely to lead to volatility in core and periphery government bond markets. In particular, investors will likely remain extremely sensitive to ECB policy on asset purchases and the outlook for policy rates.

In addition, political risks could flare up from time to time, which we believe would create a larger widening in spreads than speculation about the future direction of monetary policy.

The French elections (and Italian elections if they happen) could be catalysts for such temporary volatility, but ultimately we think they should be manageable given that the fundamental macroeconomic backdrop should remain supportive and that the most market unfriendly outcome, the election of an extremist candidate as French President, is unlikely to be realised.

Overall, therefore, we expect elevated volatility with occasional sharp spikes in rates and a widening in periphery spreads, that then subsequently die down. Ultimately, however, we think government bond yields will move higher over the course of 2022.

Credit to remain supported but lag stocks

European credit has suffered recently due to concerns around Covid and monetary policy changes but beyond a transient period of weakness, credit spreads are expected to regain their poise.

Credit fundamentals should continue improving in 2022 as leveraged companies in the BBB and high yield space retain prudence. Interest coverage has notably improved, while leverage has fallen, which to us implies that default rates are likely to remain low in 2022. Angst around a more hawkish ECB remains but we believe there is still reasonable liquidity that would probably flow into credit given the attractive income pick up relative to negative yielding government bonds. Volatility seems set to rise in 2022 from the recent low levels to which investors have become accustomed. Banks remain vulnerable credits and continue to warrant some caution, with investors expected to remain focussed on systematically important institutions.

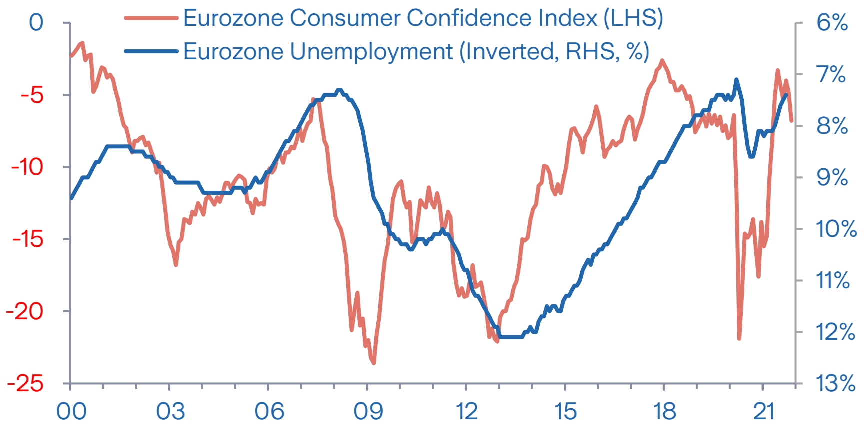
We expect European ABS to remain supported by a stronger economic recovery, fiscal support, low yields and robust housing markets across Europe. Senior ABS tranches remain well protected given current credit enhancement levels. At the same time, despite many bonds trading at negative yields, covered bonds should also remain supported due to negative net supply, continuous demand from ECB purchase programs and low loss risks given regulatory support and strong housing markets through Europe..

Equities should benefit from continued economic growth

We expect that 2022 will be another positive year for Eurozone equities overall, as strong economic growth translates to decent profit growth as well, while P/E ratios remain around current levels or expand further. The early and mid-part of an economic cycle tends to favour cyclical and value-oriented sectors as their earnings tend to rebound sharply. While high inputs costs are a concern and a potential challenge to margins, earnings should remain healthy as companies have pricing power. Higher yields should also favour banking stocks. However, while equity returns are expected to be strong, the outstanding returns of 2021 are unlikely to be repeated, while realised volatility may be higher.

Within the Eurozone, we think Italy has the most potential to see a re-rating from investors as the reforms initiated by Prime Minister Mario Draghi and the rolling out of the NextGenEU initiative gradually bear fruit. Of the big four Eurozone economies, Italy has announced the most ambitious use of the funds available, applying for the full allotment of loans and grants and accompanying these with wide-rannging structural reforms.

Consumer confidence at high levels as unemployment falls



Source: Bloomberg

Germany

Outlook

- Another year of strong growth in 2022, but some vulnerabilities to Chinese growth in the near term
- The new coalition government agrees to accelerate the green transition
- Supply-chain issues should begin to ease causing inflation to fall back

Implications

- Bund yields to move higher gradually, especially once Covid concerns diminish
- Corporate profits and equities to gain further as the global economy continues to grow at a strong pace
- Germany to take the lead in Europe and globally in terms of the green transition for large economies

Risks

- The Covid epidemic weighs on growth for longer than expected
- High inflation persists and leads to increasing discontent amongst the general public
- Exposure to China weighs on the export sector for longer than expected

Don't stop at the traffic light

After the elections on September 26, Germany has a new government, a so called 'traffic light' coalition of the SPD, Greens and FDP led by Olaf Scholz as Chancellor. While Angela Merkel's leadership after so many years may be missed, especially in times of crisis, Scholz is an experienced politician. As finance minister of the outgoing CDU/SPD coalition government, he helped steer the economy through the Covid crisis by loosening the fiscal purse strings, and pursuing innovative measures such as short-term work schemes and relaxation of bankruptcy laws. At the EU level, he was a leading figure in helping negotiate and design the NextGenEU initiative.

The relative speed with which this coalition of three quite different parties has come to a policy agreement is also encouraging and the coalition plans do not lack ambition. In particular, it aims to accelerate the green transition in Germany, while raising the minimum wage substantially but not increasing the overall tax burden. There are also some significant near-term challenges for the Germany economy that this new government will have to face.

Higher inflation and weaker growth

Germany saw higher inflation in 2021 and weaker growth than the Eurozone overall. Admittedly, the weaker growth partly reflects the fact that Germany experienced a shallower recession in 2020 than many other Eurozone countries and so a less strong rebound. Nevertheless, this trend of somewhat weaker growth and higher inflation than the Eurozone average is likely to continue in 2022, but Germany remains an economic powerhouse with a lot of strength and underlying resilience.

Germany is the third largest exporter in the world (behind the US and China), with exports accounting for around half of its economic output. Indeed, Germany exports around twice as many goods as the fourth largest exporter in the world, Japan. Germany is also the world's largest exporter of cars, vehicle parts and packaged medicines

Orders outstrip production

For the German industrial sector, 2021 was a difficult year. In late 2020 there was a sharp bounceback in production as factories re-opened and global demand for manufactured goods surged as countries exited severe lockdowns around the world. However, in 2021 production growth stalled, unable to meet demand, with problems in the global supply-chain affecting the ability of companies to access key materials and inputs, especially semi-conductor chips. The problems were particularly acute in the auto sector, which is also still trying to adapt to the ongoing transition to electric vehicles.

Supply-chain issues should improve

However, there are tentative signs of supply-chain issues improving both in Germany and globally, and our expectation is that these issues will improve significantly in 2022 as global supply chains normalise and demand growth becomes more balanced between services and manufacturing.

Admittedly, further virus restrictions are a risk, but it is very unlikely that the authorities will close factory production. Our central scenario is that supply-chain issues will gradually resolve themselves over the course of 2022 and as a result industrial output, including in the crucial auto sector, pick up.

China headwinds

However, another near-term headwind for the German economy that it must weather is an ongoing slowdown in China. Germany has particularly strong economic linkages to China because it is Germany's third largest export destination. In the near-term, the slowdown in China could therefore weigh on German growth in the first half of 2022, especially as there is often a delayed impact from economic conditions in China on Germany.

However, as we expect the Chinese economy to stabilise and the authorities to ensure the slowdown is not too severe, this should only be a temporary headwind.

Seizing the green opportunity

The new coalition government's stated desire to accelerate the green transition even more quickly could see Germany becoming the first large advanced economy in the Eurozone and in the world to demonstrate successfully how economic growth can be decoupled from environmental damage and increasing Greenhouse Gas Emissions (GHG).

The German government is planning, for example, to increase the share of renewable energy production from around 45% currently to 80% by 2030, and in the process phase out coal use by 2030 as well. Around 2% of the land surface in Germany has also been ear-marked specifically for wind energy production.

In the medium-term, Germany's accelerated green transition could be a boon for its corporate sector if its companies can seize the opportunity created by the extra demand in this sector and then use this know-how to increase exports to the rest of the world as it also goes through its green transition.

Surging inflation worries the public

However, another challenge that the German economy has faced in 2021 is high inflation. This is clearly not a challenge unique to Germany, but its inflation rate has been particularly high recently (reaching a record of 6% in November on the EU HICP measure, and 5.2% on the national inflation measure).

Given Germany's experience of hyperinflation in the 1930s, the public tends to be particularly sensitive to any signs that inflation is getting out of control. These are

Orders for German goods exceed production capacity

Source: Bloomberg

often related to concerns that the ECB is ‘going soft’ on inflation and has lost the strong anti-inflation approach that the Bundesbank had. Indeed, parts of the German press have been highly critical of the ECB and its policymakers recently.

Fortunately, we expect inflation in Germany to fall back substantially in 2022. There have been many statistical distortions and one-off factors pushing inflation higher recently that should soon ease. For example, in July 2020 the German government cut the rate of VAT for six months in order to help boost consumer demand and spending during the Covid crisis. This had the effect of reducing inflation for the rest of 2020, but increasing it in 2021, once VAT returned to its original rate. This effect will come out of the annual price comparison in January 2022, and by itself could subtract around one percentage point from headline inflation early in 2022.

More taxes

In addition, a CO_2 tax was introduced in January 2021 that was responsible for another few tenths of a percentage point increase in inflation, but this should not add further to inflation in 2022. Another statistical effect comes from the weighting of the inflation basket in 2021 compared to 2020 because of different amounts of consumption of goods and services, especially leisure travel, in these two years due to the Covid crisis. While the details are complicated, the upshot is that inflation was boosted by around another half a percentage point and this effect should also reverse or at least not be repeated in 2022.

Finally, oil price increases as the global economy reopened led to strong base effects pushing up energy inflation in Germany and elsewhere, but these effects should dimmish substantially in 2022 if oil prices stay around current levels and even if they increase a bit further.

There are therefore a number of statistical reasons why inflation should decline early in 2022. Admittedly, one source of potential upward pressure is the impact of high winter natural gas prices that might not yet have fed fully through to households’ energy bills, because there is often a time lag between the two.

Nevertheless, while it is difficult to predict natural gas prices and geo-political considerations may complicate the picture this time, previous European winter gas price spikes have reversed quickly once warmer weather has arrived and winter energy demand has subsided.

No signs that wage growth is out of control

Taking a step back from this long list of one-off factors, and perhaps more importantly for a medium-term view on inflation, there has not been a notable pickup in wage growth in Germany. In fact, most of the wage deals so far agreed have been quite conservative, reducing considerably the risk of a wage price spiral developing that could see higher inflation embedded in the economic system. It will be important to watch the 2022 wage bargaining round, and it would be normal to see some higher wage deals, but so far the evidence is that these will still be relatively restrained. The overall conclusion is that the chances of the German economy experiencing persistently excessive inflation are actually quite low.

Tweaking but not breaking the fiscal rules

As well as modest wage growth, the restrained economic approach in Germany is also evident in the approach of the new coalition government to the fiscal rules. It has agreed to re-introduce the so-called debt brake (’Schuldenbremse’) in 2023. Enshrined in the constitution since 2009, this commits Germany to a structural deficit that does not exceed 0.35% of GDP in any one year, unless there are exceptional circumstances. An exemption was passed in parliament in 2020 and 2021 because of the emergency situation. 2022 will also still be classified as an exceptional year where the debt brake does not need to apply, but the new government has vowed to re-introduce the debt brake in 2023.

However, the details of the coalition plans suggests there will still be some additional fiscal flexibility, even when the debt brake is re-applied. For example, the way that the structural deficit is calculated will be adjusted, allowing for more borrowing to take place by raising the estimate of potential growth for the German economy. The state investment bank, KfW will also be given more resources that it can leverage up to borrow (and lend) more, as will possibly other state-owned companies as well.

Bund yields could go positive

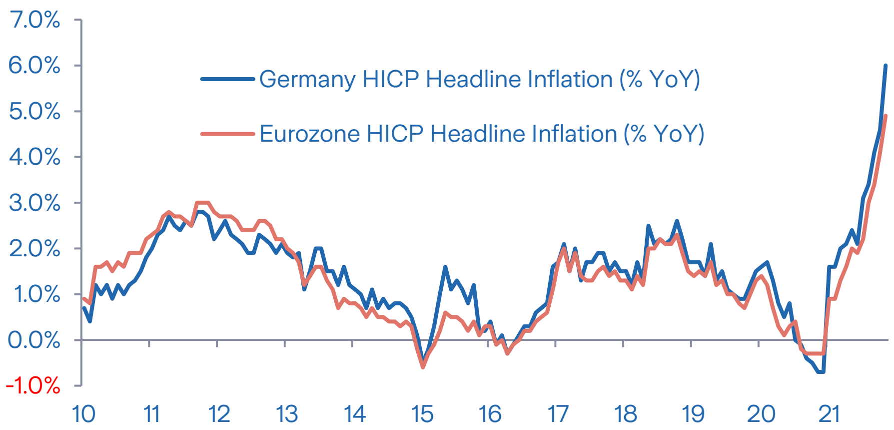
We think 2022 could be the year when German 10yr Bund yields turn positive for the first time since 2019. We expect this to occur as a consequence of the ECB gradually reducing sovereign bond asset purchases, and preparing the ground for rate hikes in 2023, while the German and wider Eurozone economy continue to grow at a strong pace.

Indeed, depending upon the state of the economic cycle in 2023, we think there is even a chance that the ECB exits negative deposit rates that year, which would likely put further upward pressure on Bund yields

Equities to see another strong year

Germany’s equity market had a strong year through most of 2021, hitting fresh record highs many times. Despite falling back on renewed Covid concerns towards the end of the year, the market is still up around 14% at the time of writing. We expect another strong year in 2022, as the key profit drivers for German companies remain in place, especially given our expectation of strong global growth to which German companies are particularly sensitive.

German and Eurozone inflation hit record highs in 2021



Source: Bloomberg

Switzerland

Outlook

- Economic growth has peaked but should be resilient in 2022
- Consumer price inflation is unlikely to become a problem, with domestic price pressures still benign
- The SNB is set to leave policy unchanged, with rates on hold and limited FX interventions if required

Implications

- Upside to bond yields is limited as policy rates are left unchanged and domestic price pressures are anchored
- The Swiss franc remains highly valued, though strong fundamentals will continue to limit potential weakening

Risks

- An unexpected and disruptive change in SNB policy
- Sharp and broad based appreciation pressure on the Swiss franc
- A failure of global supply chain pressure to ease

The Swiss economy grew at an above trend pace in 2021, with all sectors contributing

The Swiss economy is resilient, supported by strong global demand for manufactured goods. The level of GDP rose above its pre-Covid level in Q3, boosted by brisk private consumption, particularly in services. As expected, the scarring left by the Covid crisis has been smaller compared to many other regions. This foremost reflects a highly diversified economy with a solid manufacturing base and a large pharmaceutical sector, with resilience during lockdowns and the ability to reap the benefits of the sharp global recovery. Domestic consumption has also been firm, partly reflecting less cross border shopping. Tourism is still struggling though, given the collapse in international travel, with international tourists still down by almost half compared to the pre-crisis level.

Manufacturing should remain an engine of growth, despite supply chain issues

Looking forward, the global economy is set to expand at a solid pace in 2022, which should provide a tailwind for Swiss exporters. While many countries have seen bottlenecks and supply chain issues limiting production, Switzerland appears to have been relatively spared. This likely reflects a combination of factors, including less direct exposure to the hard hit auto sector as well as the diversified economy, which has allowed for some on-shoring of supply. Semi-conductor shortages are an issue though and improved supply will be required to ensure a resilient recovery. Moreover, the backlog of orders appears to have peaked but they are still elevated, indicating that it will take time to work down unfilled orders. This provides an additional tailwind for the first half of 2022, but could also be disruptive to the expansion.

Tight capacity is supportive for jobs and investment

Businesses are expanding capacity. Job growth accelerated in H1 2021 and the unemployment rate is approaching its pre-Covid level. Job vacancies have risen to an all time high while the number of job seekers has fallen sharply, though still at a level above its pre-crisis level. It appears that there is still some capacity for businesses to expand their work force, but conditions are becoming tight.

A tight labour market coupled with strong demand and favourable financial conditions bodes well for capex to be a growth driver over the coming quarters. Equipment and software investment recovered relatively swiftly in 2020 but have been subdued since then and are still tracking well below the pre-crisis level, providing potential upside. While the fundamental outlook for investment is strong, there is a risk that investment activity is held back by the tight supply of capital goods. This will be key to monitor as weak investment would weigh both on capacity and productivity.

Inventories have been depleted, posing a risk to the outlook

Inventories initially surged during Covid lockdowns but have since been depleted, with accelerated drawdowns in Q2 and Q3. We expect businesses to aim to restock, both in Switzerland and globally. This should provide an additional support to the recovery and poses an upside risk to demand. However, given acute supply chain constraints, restocking could be delayed, reducing the ability to manage inventories and production in an optimal way and potentially weighing on productivity. Just as with capex spending, this is a risk to the outlook.

Government support measures will continue to be scaled down

Government support surged during the crisis and remained expansionary in 2021. Looking forward, the economy has benefitted from timely and effective support measures that helped to prevent a deeper drawdown in activity. As a result, despite large scale fiscal spending, the debt situation remains favourable, with the general government debt-to-GDP ratio rising from a benign 40% in 2019 to an estimated 43% in 2021. The capacity to provide further support measures – should they be needed – is high. The government has also signalled a pragmatic stance to reduce the fiscal deficit. A sudden shift towards stricter fiscal consolidation is not expected.

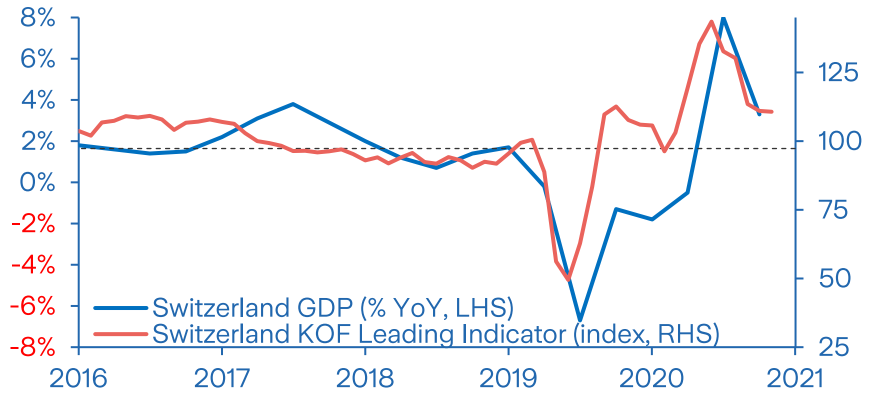
A strong labour market bodes well for sentiment and consumer spending

Household confidence has risen sharply compared to its pre-Covid trend, fuelled by a strong labour market, booming industry, a relatively benign pricing environment and highly favourable financial conditions. Against this backdrop, the outlook for consumption is positive. That said, retail spending has already seen unusual strength, as Covid restrictions limited cross-border shopping and helped lift domestic spending. Real retail sales has risen by 6% since the end of 2019, compared to only 1.5% during the two years prior to the crisis. We suspect the strong past performance will limit upside over the coming quarters.

Domestic price pressures are benign, leaving inflation relatively modest

Consumer price inflation (CPI) has risen but is low from a global perspective. Unless oil and energy prices rise further, we expect the annual headline CPI inflation rate to peak at around 1.7% in early 2022, before falling back towards 1% over the course of the year. This leaves the forecast for average annual CPI inflation a bit above 1% in 2022, up from 0.6% in 2021 and above the SNB's latest forecast of 0.7%. To a large degree, the upswing in inlation is a reflection of energy prices, while underlying domestic price pressures are benign. Nominal wages, for example, are estimated to have risen by only 0.1% YoY in Q3, indicating that downward pressure on costs and prices persist. While wage growth should strengthen amid a tight labour market, we do not expect this to become a factor that drives inflation markedly higher over the

Leading indicators signal resilient growth



Source: Bloomberg

Note: Dotted line shows 10yr average GDP growth

coming year. And while businesses benefit from strong external demand, it is unlikely to translate into an inflationary impulse given ongoing currency strength.

The SNB is set to leave monetary policy unchanged

The SNB left policy unchanged in 2021, with deeply negative rates and relatively limited FX interventions. This left the SNB's balance sheet slightly up over the course of the year, reaching 145% of GDP by the end of Q2, having surged in 2020. Despite the elevated balance sheet, we anticipate the SNB will maintain its current policies, with rates unchanged and limited FX interventions to stave off pressure on the currency if required. Looking beyond 2022, we expect the SNB to lag behind the ECB in tightening policy, with no rate hikes pencilled in for 2023 either.

The Swiss franc is in strong demand. While the currency has traded in a fairly narrow range against the dollar over the past year, recent strength against the euro appears overdone, particularly given the more constructive policy and growth backdrop for the Eurozone. That said, the Swiss trade balance has surged, generating strong fundamental demand for the currency, which we expect will persist. This limits any marked depreciation pressure on the franc, while the SNB is expected to continue to act if the currency moves sharply higher.

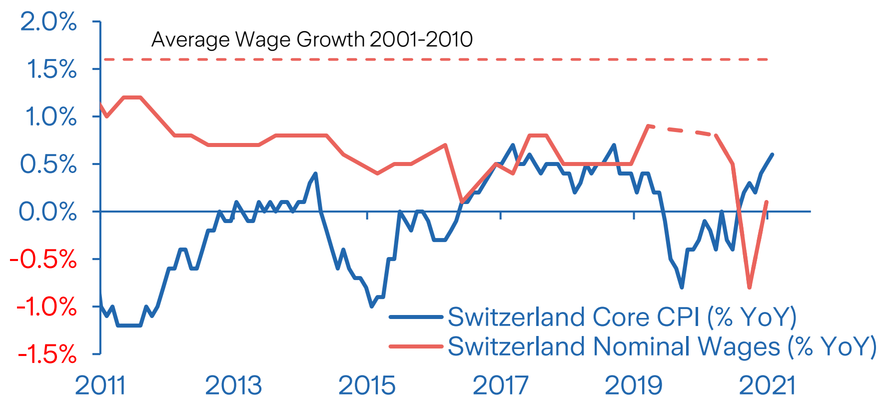
Housing market froth calls for a reactivation of the countercyclical capital buffer

Property prices rise at a steady pace, in contrast to falling rents in some segments, leading to a further buildup in imbalances in the housing market. A sharp rise in the price-to-rent ratio is a cause for concern, as it highlights an ongoing dependency on low rates and price increases to sustain developments. Despite the strong recovery in the broader economy, house prices are also elevated relative to household income. While mortgage lending is contained and affordability is not an issue at current low mortgage rates, we suspect that the SNB will monitor the housing market closely over the coming year. In particular, the countercyclical capital buffer was deactivated during the Covid crisis, to ease conditions for banks and support the economy. Given a resilient banking sector and the strong economy, a reactivation of the buffer appears prudent.

Government bond yields should remain negative or close to zero

Swiss bond yields have risen from their lows in 2020, but the whole yield curve is still supressed below zero. Bond market pricing has, however, been sensitive to global factors, with news on global inflation, policy and Covid developments leading to bouts of volatility. We suspect these dynamics will continue into 2022, reflecting the diverging forces that are impacting financial markets and the global economy. Looking through the volatility, yields should edge modestly higher through the year as growth is strong, while global central banks continue to unwind stimulus. That said, given benign outlooks for SNB rates and domestic inflation, and with relative tight supply and demand conditions in the Swiss government bond market, near-term upside to Swiss yields remains limited.

Weak wage growth anchors inflation



Source: Federal Statistic Office, Bloomberg

Note: Dotted line for wages show interpolated data

Japan and South Korea

Outlook

- Consumption will pick up amid pent up demand and public support, but consumers are likely to remain cautious
- Capex should recover from supply bottlenecks, driven by digital transformation and re-sourcing from abroad
- The stimulus package will avoid a fiscal cliff, while the Bank of Japan is expected to remain supportive

Implications

- Government bond yields are expected to remain flat, slightly above zero
- The equitiy market should be underpinned by healthy corporate earnings growth, fair valuations and foreign demand
- Yen weakening is likely to continue for the time being, although in a volatile manner

Risks

- Another outbreak of a new Covid mutation and a renewed state of emergency would harm capex and consumption
- The government fails to implement its growth strategy while focusing too much on redistribution of income
- Foreign investors lose faith in Japan's ability to restructure

2022: The year of the Tiger

The tiger is a symbol of strength in the Chinese zodiac that is also used in Japan, where it starts on January 1 instead of the Lunar New Year. The strength of the tiger is somewhat aligned with our optimistic outlook for Japan's economy. In Q3 2021 Japan's GDP contracted at an annualised rate of 3% in sequential terms amid the negative impact of Delta infections and bottlenecks particularly in the auto sector. However, the economy is now picking up momentum that should carry over into early next year.

'Sayonara' Covid?

The Covid wave in August and September 2021 was the most severe in terms of new infections, though slightly less intense in terms of mortality. In the meantime, infections have now become very low, while the two-dose vaccination rate rises above 75%, the highest among the G7 countries, with supply of medication also improving. Another pickup in new infections at the start of 2022, with Q1 being the coldest period of the year, is certainly a risk. However it seems unlikely that Japan will witness the same devastating impact as the latest wave, when several major prefectures had to be put under a state of emergency.

Consumption is expected to pick up steam in the first half of 2022

Private consumption should pick up again amid lower Delta infections, a normalisation in auto supply and cash handouts to households included in the latest fiscal package. In addition, face-to-face services consumption should benefit from the resumption of the 'Go To' campaign in February, which subsidises travel related expenditures by JPY 10,000 per person and night, 30% travel discounts and regional coupons until summer. This campaign has been sucessful in stimulating domestic travel in prior instances, before Covid related travel restrictions had to be employed.

However, while many consumers maintain their cautious attitude, demographic challenges will intensify and supply bottlenecks may need more time to be resolved. Once pent-up demand is satisfied, the path of consumption growth is expected to normalise again for the rest of the year. We do not believe that excess savings built up during the Covid crisis will be quickly and excessively deployed, but rather assume that consumers will carefully tap into these accumulated reserves. The propensity of Japanese consumers to spend is far lower than in the US, and precautionary savings for retirement are common. A shift in the workplace towards more home-office may also restrict services and consumption such as eating and drinking after work together with colleagues, even though opening hours and alcohol restrictions for bars and restraurants have recently been lifted.

Furthermore, department stores and electronic retailers will continue to suffer from the lack of Mainland Chinese tourists, as China's authorities are likely to maintain their strict regulations for outbound tourism until the second half of 2022, and Japan's strict rules for inbound tourism are also unlikely to be relaxed quickly.

Rising earnings and digital transformation will continue to drive capex

In our 2020 outlook, we mentioned that digital transformation is a major topic for lifting capex. This story has not changed, but has become even more dynamic. According to the Tankan, the corporate survey conducted by the Bank of Japan, capex plans for the remainder of this fiscal year ending on March 31 are strong and likely to remain solid throughout FY 2022, driven by digital transformation and some onshoring of overseas capital investments, with the semiconductor industry serving as an example. Software investment keeps accelerating both in the manufacturing and services related industries, following a Covid-induced setback.

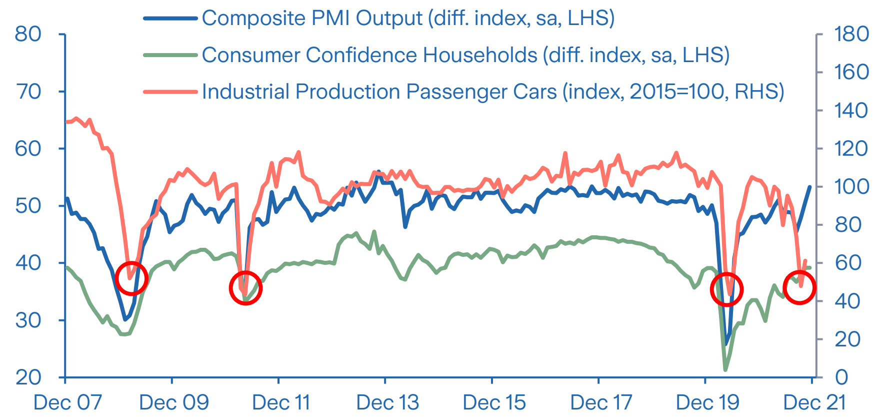
PM Kishida is putting a major focus on 'New Capitalism'. A government expert panel has formulated a growth strategy that intends to stregthen innovation by setting up a JPY 10tn university fund for advanced technologies, investing into digital transformation both in the public and private sector and by promoting clean energy technologies. Some of these measures have already been the focus of his predecessors, PM Suga and PM Abe. The Kishida government is also launching the 'Digital Garden City Concept', that is promoting digital transformation among SMEs and regional banks, supporting 6G technologies and improving the information and communication technology in education. In the category 'Economic Security', the government expert panel is also supporting building new domestic semiconductor production plants as well as promoting next generation data centers across Japan.

Rising capex will not only be a topic for the manufacturing industries, but also for service related companies investing in labour productivity enhancing automisation processes and equipment amid the increasing challenge to employ qualified domestic staff.

Export recovery should continue

Based on our global macro scenario, demand for Japanese goods is likely to remain brisk. Supply constraints for semiconductors as well as auto parts due to Delta virus related lockdowns in some ASEAN countries like Malaysia, Thailand and Vietnam had a severe impact on auto and electrical machinery related companies in Q3 and early Q4 2021. Following an increase in vaccinations in these countries, supply conditions have started to improve again and are expected to normalise in 2022 provided another wave of new virus infections is avoided. The swift recovery in the Manufacturing PMIs in these countries are encouraging for Japanese manufacturers. Another risk is the ongoing slowdown in

Auto production collapse in line with Lehman, Quake, Covid shocks



Source: METI, ESRI, Markit, Bloomeberg

China's economy, Japan's biggest trading partner. Based on our assumption of a bottoming out of the credit impulse and public measures to support the economy we do not expect the drag on Japan's exports to be substantial.

A fiscal cliff will be avoided

PM Kishida's government has announced a JPY 78.9tn fiscal package that includes various spending measures and loan provisioning. Fiscal spending amounts to a record high JPY 55.7tn, with expenditures targted at Covid prevention and re-opening measures, the previously mentioned 'New Capitalism' projects as well as measures for disaster prevention and enhancing infrastructure, safety and security. However, the overall direct impact on GDP is likely to be smaller than the JPY 30tn envisaged by the government, which would make up 5.6% of GDP.

We believe that the impact on GDP will be smaller than the headlines suggest, and will mainly depend on how much of the fiscal transfer from the government to households and companies will be spent for consumption and capex. We estimate a boost to GDP in 2022 of about 1.5%, which is still substantial. A fiscal cliff is likely to be avoided in 2022, but may become an issue in 2023. The ruling LDP will certainly maintain a generous expenditure policy at least until the Upper House elections in July, where half of the seats are due to be elected for a term of six years. That may be one reason why PM Kishida emphasised that now is not the time for fiscal constraint. As opposition parties have recently proven that they are able to cooperate on a tactical basis, the LDP and PM Kishida will try to keep fiscal policies running smoothly and avoid any pre-emptive tightening before these important elections

Our scenario of neither deflation nor inflation risks suggests monetary policy will remain stable

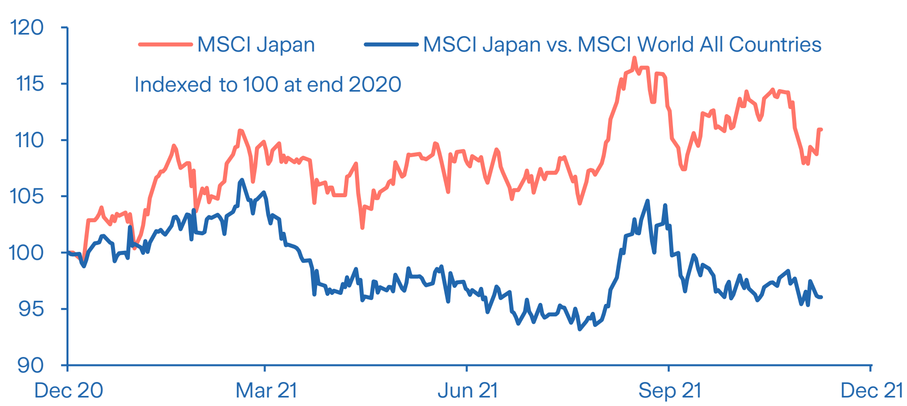
The latest CPI prints show that inflation is hovering around zero, while core-inflation ex fresh food and energy is negative, though distorted by an administered cut in mobile communication fees. Higher oil and other commodity prices should temporarily lift core inflation (which in Japan includes oil) to above 1%, but overall we believe that CPI inflation will remain anchored in the 0-1% range despite surging producer price inflation and increasing inflation expectations, as we do not foresee a strong rise in basic wages, while the semi-annual bonus mainly depends on the corporate profit outlook.

While inflationary concerns appear to be contained for now, the Bank of Japan's (BoJ) monetary policy is expected to remain stable. Yield curve control (YCC), the negative interest rate policy (NIRP) and tapering purchases of JGBs, ETFs and JREITS will be maintained. However, there is an opportunity for the BoJ to shift its zero percent yield target from ten- year to five-year yields in the second half of 2022 after the Upper House Elections. Furthermore, a close eye needs to be kept on the government's choice as to who will replace two BoJ board members in July and their policy stances. Towards the end of the year the focus will be on talks of who could replace BoJ Governor Kuroda and his two deputies in spring 2023.

Positive equity market outlook

We maintain a positive stance towards Japanese equities in 2022 amid a solid earnings outlook, reasonable valuations and room for foreign investors to re-discover the market. Following PM Suga's resignation, it appeared that investors had started to appreciate the attractiveness of Japanese equities, but their enthusiasm was short lived amid PM Kishida's talk about focusing on a redistribution of income. We believe there is room for the MSCI Japan to move back above its recent 30-year high in 2022 and to outperform the MSCI World in the first few months of the year given Japan's post-pandemic recovery, the outlook for corporate reform and supportive public policies. The focus on PM Kishidas redistribution policy is neglecting the growth element of his economic policy. We also believe that the reform of listing standards at the Tokyo Stock Exchange in April by grouping companies into the three new market segments - prime, standard and growth - may attract some investor attention, even though previously planned bold changes have been watered down.

Two phases of outperformance of Japanese equities were short-lived



Source: MSCI, Bloomberg

South Korea's success story will continue, albeit at a more moderate pace

South Korea, together with Taiwan, was a core beneficiary of the global surge in demand for semiconductors and electronic products. Exports reached a record high recently, and will remain brisk into 2022. However, the pace of growth will significantly slow once global inventory replenishment has been completed. Growth in global demand for key electronic products as well as memory chips will soften amid the shift from goods to services demand as mobility is expected to increase as spring approaches in the Northern hemisphere.

Private consumption is likely to fill the slack of weaker exports as the two-dose vaccination rate has climbed above the 80% mark in December 2021 and mobility should normalise. Fiscal policy is likely to stay accomodative, with another supplementary budget to be implemented after the highly contested presidential election scheduled for March. We expect two more 25 bps policy rate hikes by the Bank of Korea in 2022, which should help to contain inflationary pressures, particularly in the housing market, and enable the 2% inflation target to be met.

Mainland China and Taiwan

Outlook

- China is facing an uphill battle to counter downward pressures from the ailing property sector
- Consumption will recover once mobility restrictions can be eased on a more sustainable basis
- China is in a major transition phase that requires well constructed and implemented policies

Implications

- Both fiscal and monetary policy will be less tight than in 2021, but stimulus will occur in a very targeted manner
- The gap between producer and consumer price inflation is likely to narrow
- Following the 2021 slump, valuations of Chinese equities have improved, but they may need time to outperform again

Risks

- Covid waves could return, hampering mobility and services consumption while creating more supply bottlenecks
- China's relationship with major global players and trading partners does not improve
- The property sector experiences major defaults that are badly handled by the authorities

A quick view on political aspects related to China's growth outlook 2022

2022 will be the year of the Tiger. In the case of China, the tiger has to prove that he can fight back after being hit in the second half of 2021, when growth collapsed close to a standstill. Delta virus related lockdowns in major provinces as well as the downturn in the property sector have hit China at a time when the Communist Party is looking back at its achievements since its foundation 100 years ago. The Chinese government is aware that it has to adjust its policies to match President Xi's 'Common Prosperity' philosophy without completely neglecting growth targets. What is clear, however, is that 'quality' of growth will trump pure 'quantity' as China moves to its next development stage.

With the government announcing that it has achieved its goal of becoming a moderately prosperous society in all respects, the target is now to 'seek progress while maintaining stability', a goal China will be measured on before the major Communist Party Congress convenes in Autumn 2022. New leadership under the helm of President Xi, who is likely to be re-elected for a third five-year term and who has been lifted to the same ideological level as Mao Zedong and Deng Xiaoping, will need to achieve its environmental and social targets without neglecting economic growth. China has abandoned setting absolute growth targets for each year and is now taking a more flexible approach. The Economic Work Conference will convene in mid December 2021, to draft China's economic targets for 2022. It seems likely that a growth range of 5-5½% will be communicated.

A slow start into the new year, before growth picks up speed again

We expect China's GDP to grow 5.3% in real terms in 2022, following an estimate of 8.2% for 2021, with the latter number artificially distorted due to the big statistical growth overhang from 2020. Indeed, growth had slowed to below 1% in Q3 in annualised sequential terms and is likely to have picked up only slightly, to around 3% in Q4. Above 5% growth would still be in line with the implicit average annual growth target of 4.7% that is required to double China's real GDP by 2035, a target that President Xi had given at the 5th Plenum a year ago. We envisage a slow start to the year, with still weak growth in Q1 amid persistant lockdown measures around the Winter Olympics and a weak property market. Our growth outlook for the remainder of the year is more optimistic, as we believe that fiscal and monetary support measures, which started to kick in in Q4 but will only become effective in Q1 2020, will play out favourably as multiplier effects spur growth into the second half of 2022.

A word of caution referring to GDP forecasts for China, as these do not adhere to international standards and leave scope to push growth forecasts in both directions dependent on how the deflator for sub-components is calculated. As the capex deflator may be tilted towards high producer price inflation, the negative impact of property investment may be more accentuated, which can shift GDP forcasts to the 4-5% range for 2022. Some alternative activity indicators are supporting these lower forecasts, while the official GDP releases tend to be tilted to the upside.

The consumption outlook depends on Covid, the property market and labour market conditions

Delta virus induced lockdowns had a significant negative impact on services consumption in 2021, and this negative impact may even accelerate during the Winter Olympic Games and Lunar New Year in February. In 2021, China's Covid infection curve went up and down several times, causing severe mobility constraints in several major cities and provinces due to the zero-infection policies. Assuming a slowdown of infections over the summer and significantly more booster jabs we believe that consumption will pick up again as the year goes on, provided there is no new mutation urging renewed lockdown measures.

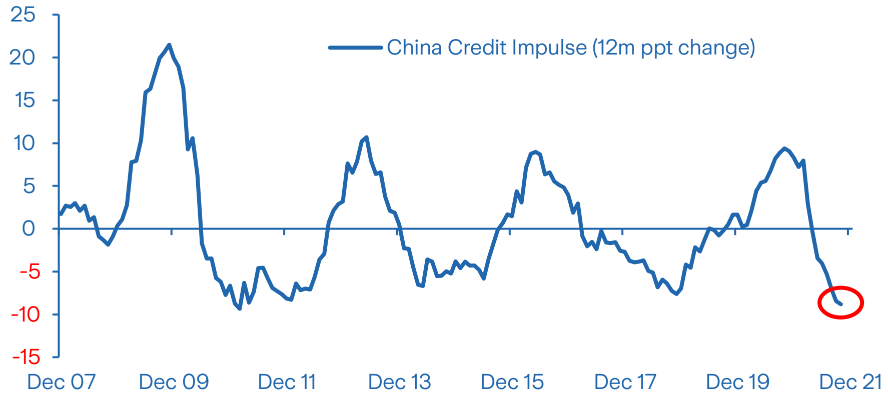
As a big chunk of household wealth is locked up in property investments, a further significant deterioration would have a negative impact on consumer confidence. The other major impact on consumer confidence is related to the labour market. Even though the surveyed unemployment rate in urban areas has fallen significantly from 6.2% following the eruption of the Covid crisis in Wuhan to only 4.9% in October 2021, clearly below the 2021 target of 5½%, we do not believe that the labour market has yet fully recovered when incorporating labour related surveys. The situation of migrant workers still appears to be particularly vulnerable. Layoffs in the property service as well as the private tutoring sector, following regulatory crackdowns, confirm that the labor market still relies on public support measures.

China's property market will need more time to rebound

China's property market was still in rather good shape in the first half of 2021, but conditions deteriorated significantly in the second half amid the government tightening the screws on lenders and property companies by implementing the 'three red lines' policy. The near collapse of China's major property developer Evergrande had a significant negative impact on confidence in the property market for home buyers, suppliers and employees in the construction sector. Property new starts and sales as well as real estate investment slowed significantly, while house prices according to the 70-city index fell for the second month in a row in October 2021. Far less construction workers were hired after the summer 2021.

The introduction of a property tax scheme on a pilot basis for ten cities, excluding rural homes, which has been a topic discussed for

China's credit impulse is likely to bottom out in H1



Source: Bloomberg; Note: Credit impulse measures the acceleration of credit vs GDP growth

more than twenty years, is also weighing on sentiment.

We believe sentiment in the housing market will not recover quickly even as mortgage quotas are eased and local governments and banks are urged by the central government to work together to stabilise the property market. The damage is done for now and is likely to only start recovering in the second half of 2022. Evergrande is likely to restructure its liabilities on an orderly manner and we don't expect this to be a 'Lehman moment' for China. Please also refer to our Topical Thoughts paper 'Evergrande: A canary in the coalmine?' published recently. Meanwhile, rental construction should remain more stable.

Export growth is likely to slow

Export growth has supported China's economy throughout 2021, driven by both strong volume and export prices. Net exports, incorporating imports, have contributed positively to China's strong GDP print in 2021. This is likely to change in 2022, as we suspect that the contribution of net exports will likely hover around zero. Demand for Chinese products, particularly in the field of electronics, furniture and toys, is expecetd to taper off in Western countries as consumption will shift away from goods towards services like travelling, dining and entertainment. Frontloading of buying Chinese goods to avoid supply bottlenecks may also come to an abrupt end.

PPI vs. CPI inflation gap is expected to narrow

In 2021, producer prices moved from deflationary territory to a multi-decade high of 13.5% YoY in October, driven by surging material prices due to supply bottlenecks and political pressure to reach environmental targets. PPI remained high at 12.9% in November. Meanwhile, consumer prices increased from -0.3% in January to 2.3% in November, despite being held back by pork price deflation. Pork prices had surged in 2020, up by 135% YoY early in the year due to the swine flu. In 2021, increased pork supply led to prices tumbling. In November, pork prices were down by 32.7% YoY.

We expect the PPI-CPI gap to narrow significantly in 2022 not only due to base effects. Although material price inflation will remain a topic, it should peak out, while the drag from pork prices on consumer prices is likely to wane. Consumer price inflation should also rise in sync with our expected consumption recovery.

Both fiscal and monetary policy should cautiously support growth

We expect an accomodative, but not loose fiscal policy stance in 2022. Lower land sales revenues need to be compensated by other sources, including a bigger net drawdown of fiscal deposits. While many economists expect a policy rate cut amid the deteriorating economic environment, we believe that the policy rate will remain stable. We are expecting that more targeted monetary policy measures for SMEs and green capital investments will be deployed, while a stable liquidity provision will be maintained.

Chinese equities are likely to tread water following the turbulence in 2021

Chinese equities experienced a turbulent ride in 2021, as they were pushed higher by speculative demand mainly from retail investors at the beginning of the year, up 20%, followed by a subsequent selloff that was intensified by the government targeting major internet companies for malpractices such as not obeying to data privacy laws and misusing oligopolistic structures. As these companies are heavyweights in indices like the MSCI China and HSCEI, and were also core holdings in many global funds, they pulled down the whole market by 34%, significantly underperforming global equities.

Valuations in these companies are now fair and no longer as overvalued as in early 2021. In terms of the broader market, the price-to-earnings ratio of the MSCI China has tumbled from being very expensive versus the MSCI World to being rather attractive. However, this may not immediately result in rising equity prices, as valuation can hover around cheap levels for some time before investors become more convinced by Chinese stocks versus global equities. For now, we believe it is not the right time to chase them, as better opportunities are likely to arise as the year progresses.

Meanwhile, we believe that domestic 'A'-shares, as reflected in the CSI300 index, for example, offer more attractive investment opportunities.

Taiwan's export boom is topping out

Taiwan's export performance during the Covid crisis has been stellar due to global demand for semiconductors and electronic goods. Brisk investment has also contributed, while consumption has been the weak link, as rising Delta infections finally took their toll. Taiwan had to catch up with vaccinations but is now on a good path, which should support rising consumer confidence. However, Taiwan needs to close the gap to its peers when it comes to second dose injections. Meanwhile, the export boom may taper off for the same reasons as decribed for Mainland China. However, digitalisation and automisation will remain a global secular trend that should be beneficial for countries and territories with strong expertise in technology like Taiwan, Korea and Singapore. This will also encourage more capex by chip producers both domestically and in the form of foreign direct investment.

We believe Taiwan's central bank, CBC, will hike its policy rate by 0.125 bps shortly after the Fed starts to hike, and pencil in another 0.125 bps hike later in 2022. Despite these rate hikes, we believe monetary policy will remain accomodative.

Chinese stocks are no longer everybody's darling as in early 2021

Source: MSCI, Shanghai and Shenzen Stock Exchanges, Bloomberg

ASEAN and India

Outlook

- The recovery will gain speed as the reopening paves the way for rebounds in economic activity
- Central banks should start hiking interest rates once the recovery gains a solid footing in H2 2022
- Governments are likely to embark on journeys of fiscal consolidation

Implications

- Improving corporate earnings will support equities, but tightening global financial conditions pose challenges
- Government bond yields should rise on the back of potential rate hikes by central banks
- Larger FX reserves and trade surpluses should help alleviate depreciation pressure on currencies

Risks

- Renewed Covid outbreaks trigger lockdowns and cause unexpect collapses in economic activity
- The Fed's rate hikes result in substantial capital outflows and sharp currency depreciations
- Inflation surges, forcing central banks to hike interest rates before the economic recovery becomes sustainable

The gap that Delta left behind

The legacy of 2021 will have a material impact on ASEAN's growth trajectory in 2022. Massive Delta outbreaks triggered a sharp economic slowdown across the region in Q2 and Q3 2021. Depending on how stringent and prolonged containment measures were in place, the level of economic damage in each country varied.

Vietnam was among the most affected due to severe and sudden lockdowns. Draconian restrictions have also delayed the recovery in Malaysia, Thailand and the Philippines, leaving these economies with a 3-6% output gap by the end of 2021.

In contrast, Indonesia adopted softer restrictions, limiting the economic fallout. On the flipside, Indonesia suffered the highest death rate in ASEAN.

Singapore was the brightest spot as high vaccination rates prevented Delta from spreading widly, and the country's GDP returned to the pre-Covid levels in 2021.

India's pathway was slightly different as Delta arrived about a quarter earlier in India than in Southeast Asia. Since then, India's recovery has been brisk.

We expect the speed of recovery will be uneven across countries in H1 2022 and become more synchronised in H2 thanks to higher vaccination rates. Future Covid outbreaks remain key risks to this outlook.

Private consumption to recover at different speeds across countries

Private consumption accounts for a significant share of GDP in India and ASEAN, with the exception of Singapore. Hence, how rapidly private spending improves will meaningfully impact growth momentum.

Malaysia appears to be in the best position. Malaysia's vaccination rate is the second-highest in ASEAN. Prolonged lockdowns since the end of Q2 2021 mean there is plenty of pent-up demand. Household balance sheets appear resilient thanks to high saving rates and various forms of direct and indirect fiscal support.

In the Phillippines and Thailand, the reopenings should also support consumption. However, the Philippines' high unemployment rate and Thailand's uncertain prospects in the tourism sector are likely to prevent private spending from rising swiftly.

In Indonesia, private consumption were fragile, although the country adopted looser restrictions. Weak consumer confidence, rising unemployment rates and still fragile economic conditions were likely behind the weakness. We suspect consumer sentiment will only rise meaningfully when economic prospects appear more encouraging and the uncertainty around Covid declines on the back of sufficient vaccination rates, probably in H2 2022.

Meanwhile, the recovery trend in India will continue well into H1 and is likely to slow in H2 as pent-up demand effects wane.

External strengths will energise domestic sectors

The external strength comes from two fronts: exports and foreign direct investment (FDI).

Regarding trade, we expect exports will remain supportive in 2022 as global demand is likely to stay elevated for some time. With the reopenings, Capex investment will likely pick up to narrow the gap between production capacity and external goods demand.

On the investment front, recent trends show FDI flows into ASEAN surged. ASEAN remains an attractive destination for investment given its cost advantages and well-developed networks with trade hubs in North Asia. We think FDIs will stay buoyant in the years to come.

Furthermore, the Regional Comprehensive Economic Partnership (RCEP), the world largest trade deal in terms of GDP, will come into effect in 2022. Also, more economies are keen to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). As a core member of both trade deals, ASEAN's strategic role in global trade should continue to be reinforced.

Inflation should be well contained

While price pressures have built up in other parts of the world, inflation in major ASEAN countries has been soft in 2021. We expect CPIs will remain well contained in 2022.

On the demand side, the lockdowns in 2020 and 2021 caused a significant drop in output. The recovery should gain speed given social relaxation, but domestic demand will likely take time to recover. This should prevent inflation from overshooting.

On the supply side, India and the Phillippines were the two economies that experienced high inflation due to domestic supply disruptions. We expect price pressure there to recede in 2022 as normalising economic conditions ease the supply crunch.

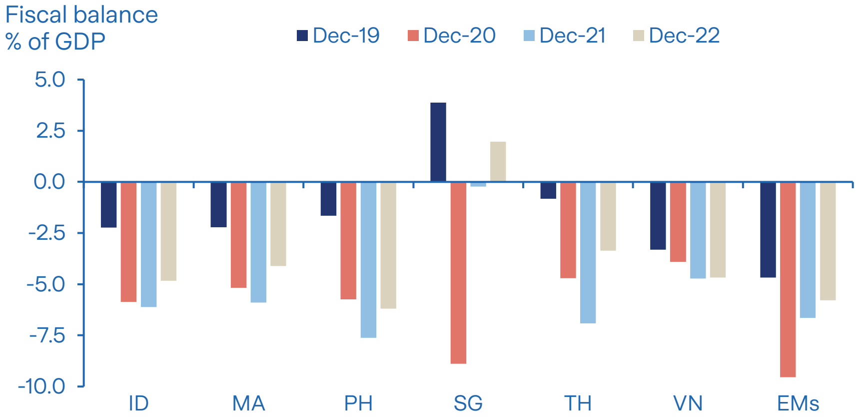
Regarding the pass-through effects from global high energy prices and supply bottlenecks, ASEAN is not entirely immute to the external price pressure. However, the domestic output gap should remain the key driving force for the inflation outlook.

One exception is Singapore, which tends to have a stronger link between domestic inflation and global prices given its high proportion of imported goods.

Central banks to normalise their policy but at a gradual pace

Given that many global central banks have raised policy rates, will regional central banks follow suit? We think the process of rate hikes will be slower in ASEAN than in other emerging markets. There are three factors for this.

Governments to embark on journeys of fiscal consolidation



Source: The IMF, 2021 and 2022 figures are projected. Countries: Indonesia, Malaysia, Philippines, Singapore, Thailand, Vietnam

First, a milder inflation trajectory will leave central banks some wiggle room to decide the timing of rate hikes.

Second, raising policy rates will depend on the domestic recovery as early rate hikes might impair the healing process of the economy.

Third, the current pressure mostly comes from the external front given the Fed's potential rate hikes in 2022. However, we think ASEAN's bonds still provide attractive yield differentials even with a slower process policy tightening.

Futhermore, ASEAN's current account surpluses and stronger FX reserves should help balance capital outflow vulnerabilites, reducing the urgency for central banks to raise rates.

We pencil in policy rate increases between 50-75bps across the region in H2 2022. Bank Indonesia (BI) and Bangko Sentral ng Pilipinas (BSP) are likely to raise interest rates the most to attract foreign capital inflows so that they can gradually withdraw from the current debt monetisation.

Fiscal consolidations are underway

Many countries have unveiled their 2022 budgets. Overall, governments expect fiscal deficits to decline given potentially higher tax revenues and lower fiscal spending needs.

Indonesia and Singapore have announced they will raise tax rates, focusing on goods services tax (GST) or value-added tax (VAT). Indonesia will hike VAT from 10% to 11%, effective in 2022, while Singapore will increase GST from 7% to 9% between 2022 and 2025.

The IMF estimated ASEAN's fiscal deficits will reduce from around 5-7% of GDP in 2021 to 3-5% in 2022. Only the Philippines will still have budget deficits of above 6% of GDP in 2022. With that, we expect a negative fiscal impulse in 2022. However, the overall effects on GDP should be modest, compensated by the recovery in the private sector.

Malaysia: Political risks to linger

2022 should be the year when Malaysia regains its strength. Conditions for growth are favourable on many fronts. Consumption should bounce back swiftly on the back of high vaccination rates. Both robust exports and strong FDI should encourage domestic businesses to invest more aggressively.

However, Malaysia's Achilles' heel remains its political instability. The country has suffered a political crisis with two changes in leadership in the past two years. The coming general election is scheduled in July 2023. In the run-up to the election, further political uncertainties might arise. Ongoing political instability potentially reduces the effectiveness of economic policy during the recovery process.

Indonesia: Reforms are key for the long-term growth outlook

The key highlight for Indonesia is the ongoing reforms of labour and investment laws, which will alter the dynamics of foreign investment in the long run. Indonesia is highly sensitive to external indirect captial outflows as more than 20% of Indonesia's government bonds were held by foreigners in 2020.

Meanwhile, rigid and less market-friendly investment and labour laws have limited FDI inflows into Indonesia. Encouragingly, reforms, such as the proposed Omnibus law, look promising to attract more FDI. We think FDI inflows will be supportive in 2022 as Indonesia appears be a bright spot for investment, especially in the mining sector, given its large reserve of high demand resources such as nickel and copper.

BI's exit strategy from debt monetisation will be another focus in 2022. Markets have been supportive of BI's monetary measures, given the urgency of policy support needed during the recession. However, investors' perceptions can shift quickly if BI continues to delay the withdrawal of the intended one-off debt monetisation.

India: The recovery continues

India's recovery has been reassuring. The fact that India's output dropped by 8% in 2020 means the country has plenty of space to catch up.

It is encouranging to see India's government continue its labour reforms and privatisations of state-owned firms. In the long run, it helps transform the country into a more market-driven and business-friendly economy. This will enhance the capacity for growth, given that India's growth was already on a declining trend even before Covid due to structural issues.

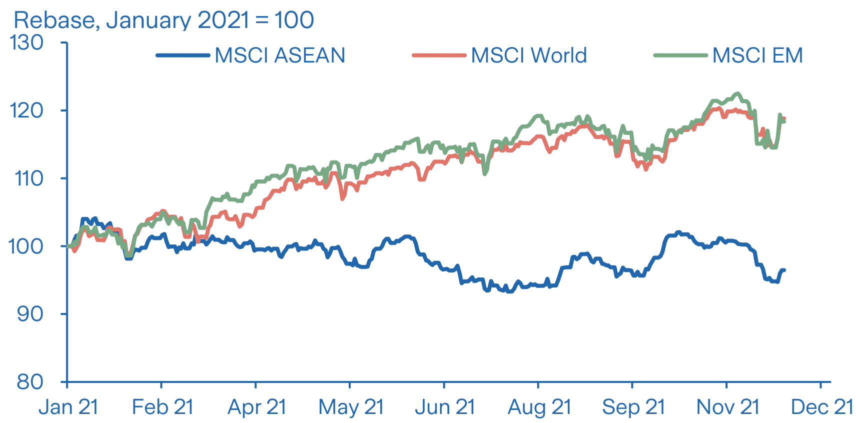
Financial markets should stay resilient amid tightening external financial conditions

Given the economic recovery, corporate earnings are likely to rebound. Improving fundamentals should support equity markets. The key headwind remains tightening external financial conditions. Hence, we think the upside for ASEAN's equities in 2022 will be rather moderate and mainly driven by domestic investors.

Bond yields should pick up as central banks start their hiking cycles in H2 2022. It is likely that demand for ASEAN's high yielding government bonds stay afloat. Despite a potential slower pace of rate hikes, levels of yield differentials still appear decent while the economic outlook should brighten, lending support to the bond markets.

Regional currencies are likely to experience some downward pressure amid tightening global financial conditions. However, central banks' more solid FX reserves and better current account positions will help balance the currency vulnerabilities. Please also refer to our recent Topical Paper, 'ASEAN reboots' for further analysis.

Better corporate earnings to lift equities, but vulnerabilities remain



Source: Bloomberg

Australia

Outlook

- Growth is expected to be robust as economic conditions normalise further
- Inflation is likely to rise but should not overshoot, helped by contained wage growth
- The labour market will likely tighten, but wage growth should be moderate

Implications

- Bond yields set to increase given a brighter macro outlook and further monetary policy normalisation
- Equities are likely to perform well, underpinned by supportive corporate fundamentals
- House price appreciation should be capped as mortgage rates are set to rise

Risks

- A new Covid strain invades vaccine efficacy and triggers the next wave of infection and lockdowns
- Inflation overshoots, forcing policy tightening at a much faster pace than anticipated
- The trade spat between Australia and China intensifies, leading to a severe decline in Australia's exports

Normalising conditions for growth

Australia was among a few developed economies that resumed pre-pandemic output levels by June of 2021. However, the year brought more challenges than initially anticipated.

Caught in the Delta outbreak that rampaged across Asia, Australia returned to lockdowns in Q3, a significant setback for the economy. On the flipside, vaccine rollouts accelerated as a consequence. At the time of writing, Australia has vaccinated more than 88% of its adult population with double doses.

With the reopening, initial signs of recovery are reassuring, particularly in the services sector. Economic conditions should normalise further, setting a solid backdrop for 2022.

The key risk to the growth outlook remains a potential resurgence of Covid, especially if any new mutation is capable of evading vaccine efficacy, triggering another round of lockdowns.

Consumption to lead the way

Private spending will be the first to thrive post-lockdown. While households received less cash support from the government than in 2020, high saving rates mean consumers still have comfortable space for further spending.

Consumption should return to pre-Delta lockdown levels by the end of 2021, enhanced by the year-end sales season. The positive impulse for private spending will likely persist until Q1 2022, setting a positive momentum for growth.

The labour market to tighten

Induced by severe Covid lockdowns, Australia's unemployment rate peaked at 7% in Q3 2020, a figure that paled in comparison with the double-digit unemployment rates seen in other countries.

The JobKeeper program proved effective in preventing severe job losses and household defaults. By Q2 2021, Australia's jobless rate returned to the pre-pandemic rate of around 5%.

Notably, the labour market remained resilient throughout the Delta outbreak and subsequent lockdowns. With the reopening, we expect the job market to tighten in H1 2022, driven by still disrupted labour supply coupled with strong demand.

However, it is worth noting that Australia's labour supply disruptions due to Covid have been less severe than in other markets. The JobKeeper program was effective in encouraging firms to retain staff during the crisis, helping reduce employment interruptions.

As pent-up demand wanes, private consumption is likely to return to a more normal pattern. A pickup in labour participation should help narrow the supply gap. The main uncertainty remains the timing of border closures, which will depend on how the global Covid situation evolves.

With that, we expect labour market tightness will ease in H2 2022 as the mismatch between demand and supply lessens.

Inflation is unlikely to overshoot

Inflation rose more than anticipated in Q3 2021, although the economy was still in the middle of the second lockdown.

Global price pressure triggered by supply shortages coupled with exuberant goods demand had pass-through effects on Australia's domestic prices. Rising home prices and strong demand for home building in the country also played a part.

From the global perspective, inflation might stay elevated for the time being, but we expect it will gradually come down. The gap between supply and demand should narrow, driven by further shifts from goods to services consumption and improving supply over time.

On the domestic front, the rebound in consumption might amplify demand pressure on prices at the beginning of 2022. However, this pressure should recede in H2 as the consumption pattern normalises. Home prices are likely to peak soon, while the demand for home building will probably subside given fading effects of the Homebuilder Grant.

The key question is whether a period of elevated headline inflation in H1 will translate into a sustainable rise in core inflation, driven by higher wage pressure. We think this is an unlikely scenario. While wages tend to rise on the back of a tighter labour market, it should not be significant enough to lift core inflation sustainably above the RBA's target range of 2-3%.

Policy rate hikes appear unlikely in 2022

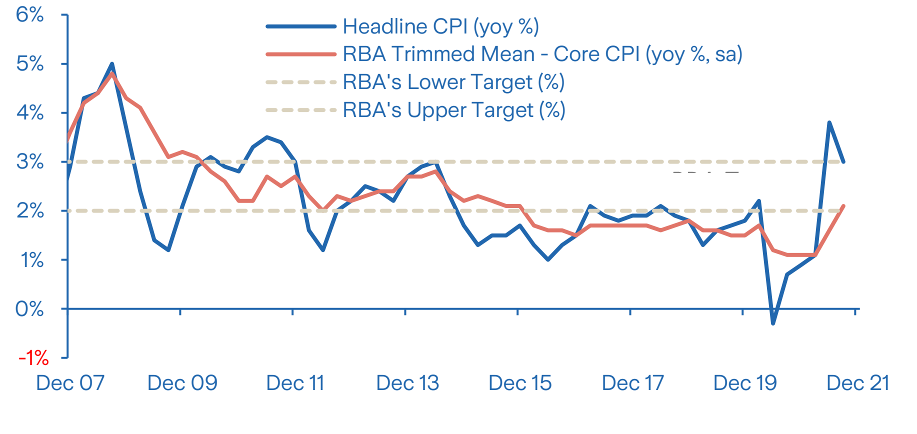
In response to the pandemic, the RBA introduced a comprehensive policy package including a total of 65bps in cash rate cuts, the term funding facility (TFF) to provide cheap funding to banks, the three-year yield curve control (YCC) at 0.1% and quantitative easing (QE).

The RBA has already withdrawn the TFF, and the YCC and tapered its QE in H2 2021. We expect it will scale down its asset purchases further in 2022. Focus is now on when the central bank will start hiking its cash rate. Given our view on inflation and wage growth, we think the RBA will remain patient and is unlikely to raise interest rates in 2022. We pencil in the first rate hike in H1 2023.

The housing boom to ease

2021 was a remarkable year for the housing market. As of November 2021, home prices for five capital cities were about 21% higher than a year ago according to Corelogic. Historically low interest rates and ample household savings on the back of generous

There is still a way to go for core inflation to exceed the RBA's target



Source: Bloomberg

fiscal support have fuelled the property appreciation. Even with the second lockdown in Q3 2021, home prices continued to rise. However, we think the housing boom will soon run out of steam. Several factors are behind this view.

First, while the higher home prices have positive wealth effects, it elevates the risk of financial instability. Therefore, authorities will likely keep a close eye on the housing market. In October 2021, the Australian Prudential Regulation Authority (APRA) raised the minimum interest buffer for residential mortgage lending to contain home loans.

Second, with the removal of YCC, short-end rates have escaped their historically low range. New mortgage rates will be priced-based on higher interest rates, which should weigh on demand.

Lastly, housing affordability has deteriorated with the surge in home prices. Given the reopening, households are likely to direct more spending towards consumption, leaving less extra space for financing a new home.

With that, we think 2022 will be a benign year for the housing market.

Exports face headwinds amid China's property downturns

According to the WTO, Australia's shipments to China account for around 40% of total exports as of 2020. Hence, China's activity levels have a material impact on Australia's trade outlook.

China's property downturn, exacerbated by the Evergrande debt crisis, has led to lower demand for construction, which is closely linked to steel production, with iron ore being the main inputs.

Iron ore prices have plunged almost 55% from the peak in June 2021. We suspect the weakness will persist in 2022.

With a potential pickup in imports given domestic recovery, trade surpluses should narrow considerably from the current elevated levels. Hence, net exports will have a limited contribution to GDP or even be a drag on growth if the trade balance turns negative.

Downward pressure on the AUD

The Australian dollar is closely tied to commodity prices and global demand for its exports. Given that exports are likely to weaken, the Australian dollar should tend to depreciate from current levels.

The trajectory of the currency is also linked to the monetary policy outlook. We think the RBA will lag the Fed and DM central banks regarding the timing and pace of QE tapering and rate hikes. A slower process of monetary normalisation might lead to widening spreads between Australian and other DM bonds, leading to capital outflows and putting downward pressure on the AUD.

Bond yields to rise further as monetary policy normalises

The removal of YCC led to a spike in yields at the short end of the curve. Further tapering of QE should translate into higher bond yields for long-dated bonds, but the rise at the short end is likely to be more pronounced. As a result, the yield curve will tend to flatten, reflecting a positive growth outlook coupled with the potential trajectory of policy tightening.

The RBA is likely to maintain the historical cash rate of 0.1% throughout 2022. With the cash rate anchored, yields, despite rising, are likely to be more modest compared to historical averages.

Equities to offer decent returns

Equities enjoyed a relatively smooth ride in 2021, supported by abundant liquidity and economic recovery optimism. The ASX 200 hit a record high in August 2021 before retreating on the back of a weaker outlook for commodity stocks and worrying news around Covid.

For 2022, we see further upside ahead, though with potentially more volatiity. On the risk side, we think headwinds will remain for commodity stocks given weaker global demand for iron ore and coal. The ASX Material Index has corrected by around 13% since August 2021.

With global central banks tapering QE and hiking rates further, the support coming from ample liquidity becomes less prevalent. However, given the strong growth outlook for Australia in 2022, improving corporate earnings should provide a solid ground for equities to attain a decent performance.

Equities to offer decent performance, but volatility will likely pick up

Rebase, January 2021 = 100

Source: Bloomberg

LatAm

Outlook

- We expect economic activity in LatAm to moderate, growing at around trend in 2022
- Mexico is expected to outperform, but idiosyncratic risk may impact business confidence
- Inflation pressures are expected to remain, keeping inflation above central bank targets

Implications

- Monetary policy tightening will continue, impacting economic activity
- Fiscal consolidation is likely to be a key driver for investor confidence and asset prices
- Local asset valuations are tempting, but elevated political and policy risks diminish the appeal

Risks

- An increase in political uncertainty undermines confidence, impacting local asset prices and capital inflows
- Fiscal deterioration and inflation lead to higher interest rates affecting economic activity
- Faster than expected US monetary policy normalisation and a sharp deceleration in Chinese economic growth

LatAm: A challenging outlook as activity to moderate after an uneven recovery in 2021

Despite the favorable external outlook, we expect idiosyncratic risks and higher inflation to negatively impact consumption and investment, leading to a moderation in economic activity. GDP growth should be around trend in 2022, with different drivers among countries. Central banks would likely continue to tighten monetary policy, signalling a commitment to achieving inflation targets and preventing a de-anchoring of inflation expectations. Vaccination continues to advance, preventing governments from imposing strict lockdowns and allowing for the reopening of the economy. This is supporting the service sector, while supply-chain bottlenecks should start to ease during the year. Fiscal deficits are beginning to reduce in most countries amid economic growth, lower fiscal spending, and favorable commodity prices, while the current account continues to be manageable.

Argentina: Economic reforms are likely but macroeconomic imbalances to remain

The mid-term elections triggered tensions within the ruling coalition, forcing a negotiation with the opposition and adoption of a more pragmatic political position. This reduced the probability of not reaching an agreement with the IMF, which we expect to occur in Q1 2022. However, we expect the government to delay the structural reforms as much as they can and only implement the reforms that guarantee the arrangement with the IMF. This will likely not be enough, however, to ensure a credible downward inflationary trend and sustainable economic growth based on a recovery in fixed investment.

Given the sharp drop in support for the government coalition in the mid-term elections and considering that there are presidential elections in 2023, we conclude that a significant fiscal adjustment will be unlikely in 2022.

As financing public spending through local debt is minimal and the government did not have access to the international markets, monetary imbalances and money issuance to fund the Treasury are expected to remain in place, which is harmful from an inflation perspective. Also, the low net reserves make it difficult for the government to continue with the current FX intervention policy, forcing it to allow significant depreciation during the year.

Therefore, the expected end of the policies of price control of goods and the freezing of regulated prices, along with the FX depreciation to reduce the gap between the official and blue exchange should create additional inflation pressures during 2022.

Higher inflation and accelerated exchange rate depreciation will require an upward adjustment to interest rates in 2022, making rates less negative in real terms. While we do not expect monetary policy to tighten enough to reduce inflation expectations, there will likely be a change in the bias of monetary policy.

The pandemic situation continues to improve, allowing for the reopening of the economy and supporting the service sector. However, the reforms to be agreed with the IMF and the low dynamism of private investment and consumption will make 2022 lackluster. Our forecast for GDP growth in 2022 is 2.0%.

All in all, we believe the government is more concerned with regaining approval for the 2023 elections rather than implementing structural reforms to reduce macroeconomic imbalances and support the economic outlook for the medium term, risking inflation remaining out of control in the short term. We forecast inflation around 52% in 2022.

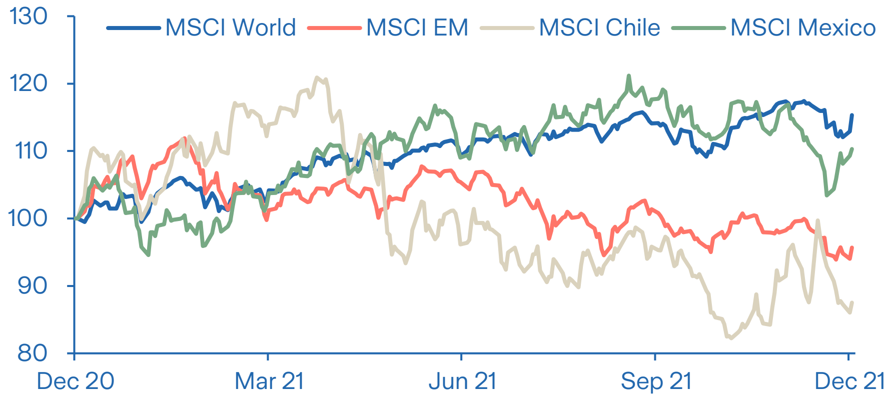
Chile: Political uncertainty and fiscal consolidation impact the economic outlook, despite higher commodity prices

Aggressive fiscal stimulus, together with an easing of monetary policy and allowing of premature pension fund withdrawals, prompted a rapid economic recovery in 2021, with GDP returning to the pre-pandemic level and closing the output gap. However, the economy is showing signs of overheating as domestic demand recovers faster than supply, which has been mainly affected by the supply chain bottlenecks, and the excessive liquidity in the economy. Consumption has been the main driver of the recovery, consistent with the strong support received by households, which is unsustainable in the coming year.

We forecast a GDP growth of 1.8% in 2022. Private consumption should decelerate as fiscal support is reduced and the liquidity provided from the pension fund withdrawals is depleted. The polarised political situation around the constitutional process leads to significant uncertainty that could keep private investment depressed, slowing down Chile's economic activity and affecting the medium-term outlook. Idiosyncratic risk is impacting business sentiment, while companies are distributing more dividends than usual. However, considering the current institutional framework, we do not expect significant changes in the existing market model. Nonetheless, this process could lead to populist policies, higher fiscal spending, and volatility in financial markets during 2022, making Chile lose its attractiveness to investors compared to other countries in the region. This uncertainty should remain until July-Sept when a draft of the new constitution is released and the approval referendum occurs.

We expect inflationary pressures to continue in 2022. Currency depreciation, high energy prices, the reopening of services, and the supply chain restrictions of goods in the context of strong demand, are areas of

Equity markets underperformed global markets, with mixed returns



Source: MSCI, Bloomberg. Re-based 31.Dec.2020=100

concern. Furthermore, the indexation mechanism of the economy keeps upward pressure on prices. Thus, we expect inflation to reach its maximum level in Q2 2022 and drop to ~4.5% by the end of 2022, but not converge to the Central Bank's target until Q4 2023, forcing the central bank to raise the MPR to 5% during the H1 2022. However, there is still some upside risk to inflation, and the central bank may consider changes to its forward guidance.

We expect a contractionary fiscal policy next year, with fiscal spending normalising and dropping by 22.5%. Therefore, in the absence of new liquidity injections, domestic demand should moderate significantly, reducing the risk of a more restrictive monetary policy. However, we cannot rule out that the new administration will promote additional spending measures, putting pressure on the fiscal deficit, inflation, and increasing financing needs.

Mexico: Better economic growth and a more stable fiscal and political outlook

We expect economic activity in Mexico to remain above trend in 2022 with GDP growth of 3.1%, driven by a positive economic outlook in the US, which will likely continue to boost the export sector and private consumption through foreign remittances. The reopening of the economy will likely continue, supporting the service sector, while the expected easing of supply-chain bottlenecks is expected to benefit the manufacturing industry. Public investment should also contribute positively to economic activity next year.

The lack of fiscal stimulus during the pandemic did not help the economy, but the austerity in fiscal spending has kept the fiscal deficit under control. However, the growing dependence on funding for the federal government from state-owned companies (particularly Pemex) may produce some fiscal pressures in the coming years. We do not see fiscal and current account imbalances during 2022.

Despite the expected deceleration in inflation, it will likely remain above the central bank's target driven by core inflation that has shown stronger and longer-lasting price pressures. The rigidity of merchandise prices, which remain high, and the increase in prices in the services sector due to the reopening of the economy, are the main likely drivers for a slower convergence towards the central bank's goal.

We expect inflation to be ~4% for 2022. Banxico continues to see inflationary pressures as transitory, so we do not expect an acceleration in the monetary normalisation process. We also estimate that the change in the bank's board will make more aggressive tightening difficult. Thus, Banxico should continue with gradual increases in the policy rate, bringing the rate to around its neutral level in the first part of the year.

The government coalition lost its majority in the Congress in the mid-term elections, which was positive for the economy and reduced the political uncertainty. Nevertheless, the President continues to promote structural reforms that may affect the investment outlook, such as energy reform. However, we assign a very low likelihood to its approval, considering the current composition of Congress. A setback to these proposed reforms could mean greater openness towards more pro-market measures that could boost investment in the medium term, thus improving the outlook for the Mexican economy in the coming years.

Political and policy risks drive the equity market, but attractive valuations and upbeat corporate earnings lift the outlook

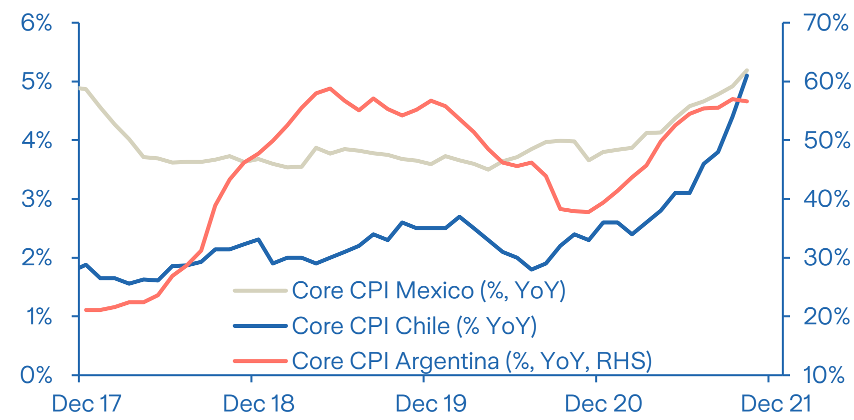
Equity markets have performed poorly in LatAm compared with global equity markets, as political and fiscal uncertainties in the region increased. However, higher commodity prices, the expected rotation to markets correlated with the economic cycle, attractive valuations, and undervalued real exchange rates improve investor confidence and the region's attractiveness, bringing foreign flows and boosting equity markets. Also, in a still low global interest rate environment, LatAm should benefit from an increase in risk appetite and the economic reopening supported by a faster vaccination. As a result, the performance gap between the MSCI LatAm Index and MSCI Emerging Market Index could tighten in 2022, but with higher risk considering the political outlook.

We expect Mexico to have a positive performance and outperform its peers driven by the stable fiscal outlook, its exposure to the US, and growth in corporate earnings supported by the positive economic outlook. Also, the higher exposure to value companies and the attractive valuations may lend support to the equity market. Risks to our positive outlook for stocks are a faster than expected tightening in the US and incresed political uncertainty due to additional noise regarding structural reforms. Also, in an environment of rallying LatAm stocks, Mexico should be lagging behind its peers with a higher beta.

In Chile, despite attractive valuations and a strong credit rating, current political uncertainty due to the social demands, polarized political enviroment, and constitutional process is limiting the upside and increasing volatility in local assets. However, the outlook could turn positive if structural changes associated with the proposed new constitutions are market friendly. The more balanced new Congress compositon is favourable for markets.

In Argentina, macroeconomic imbalances and political uncertainty will lead to low economic growth for the next year, negatively impacting investor confidence and equity markets.

Domestic factors are pushing inflation up



Source: Bloomberg

Brazil

Outlook

- Economic activity is expected to grow below trend
- Higher interest rates, a deteriorating fiscal situation and political uncertainty are likely to be a drag on domestic demand
- Inflation should decelerate but remain above the central bank's target

Implications

- We expect the BCB to tighten until inflation expectations are anchored, but easing could start by end 2022
- Fiscal credibility is needed to boost investor sentiment and the equity market
- Negative events should be largely priced into local assets, so expect positive returns, but a volatile environment

Risks

- An increase in political risk undermines confidence and impacts local asset prices and capital inflows
- Fiscal deterioration and higher inflation expectations lead to higher interest rates, affecting economic activity
- Faster than expected US monetary policy normalisation and a sharp deceleration in China

Brazil's economy to be dragged by higher inflation, tightening and fiscal uncertainty

Economic activity stalled after a promising start to the year, with GDP growth close to zero in the Q2 and Q3. Industrial production continues to be a drag on activity, remaining 3.2% below its pre-pandemic level, affected by the shortage of inputs and the impact of drought on electricity generation. We expect retail sales to remain weak, as monetary policy tightening will affect consumption in 2022. Global disruptions in the supply chain have created bottlenecks for industry, which is affecting retail sales with a shortage of goods for final consumption. On the demand side, despite the improvements in figures associated with Covid-19 and mobility, higher prices have kept demand contained. We expect supply chain pressures and higher inflation to ease in 2022, but continue to negatively impact economic activity, at least during H1 2022. The services sector, which has sustained economic activity in recent months, retreated in September 2021. Despite this slowdown, services remain above their pre-pandemic level, accelerating in Q3 2021 compared to Q2 2021. Likewise, we expect that the most affected services from the pandemic will continue to recover, boosting this sector in coming months.

While we believe the global economy should grow above trend in 2022, in Brazil we expect GDP to grow at a below trend level of only 1.0% YoY. The impact of higher interest rates on domestic demand and the effect of the deterioration in the fiscal situation and political uncertainty on business confidence explain the expected drag in economic activity. Private consumption, the most important component of GDP, is likely to decelerate. At the same time, industrial production should remain under pressure in H1 2022 as long as supply chain bottlenecks persist. Gross fixed investment will probably remain stagnant given the political uncertainty around the presidential elections, while public consumption will provide little support for economic growth.

Furthermore, the high unemployment rate, which remains above pre-pandemic levels, the drop in disposable income due to higher inflation along with the deterioration of household financial conditions due to higher interest rates, are all putting downward pressure on our economic forecast. On the other hand, if the administrative reform and privatization program gains momentum, investment sentiment will improve, providing an upside risk for economic activity.

The spending cap and social program to impact fiscal outlook, inflation expectations and business confidence

The drop in the government's approval rating and uncertainty regarding the outcome of the presidential election in 2022 have been the catalysts for the government to increase fiscal spending. The deterioration in the fiscal situation occurred after the president announced increases in the cash transfers of social programs in 2022, even though their implementation required some adjustments to comply with the established fiscal rule.

The president sent the Congress a constitutional reform, which included a reduction in court-ordered payments for 2022, and changed the methodology for calculating the spending cap, opening new spending spaces, and adhering to fiscal rules. After the announcement of the new fiscal plan, the resignation of some members of the economic team weakened fiscal credibility and the ability of economy minister Paulo Guedes to prevent additional fiscal packages.

Although the additional increase in public spending for 2022 is slight, it opens the door for other measures that increase spending in an election period, putting greater pressure on inflation and negatively impacting investor confidence since the credibility of the fiscal anchor is at stake. Moreover, the changes in the methodology to calculate the spending ceiling would translate into additional spending space under the spending cap limit, above the BRL 39bn estimated by the government, in case inflation in 2021 continue to surprise to the upside. One of the risks is that the amounts allocated to the social program will rise, increasing the fiscal deficit.

The additional fiscal spending announced by the Government should, to some extent, offset part of the fall in economic growth. However, we expect the negative impact on activity from tightening financial conditions and the increase in political uncertainty will more than offset this effect.

The depth of the economic recession in 2020 led to concerns that the public gross debt/GDP ratio would rise to around 100% during the following 2 years. However, this fear disappeared and the ratio actually fell in 2021, driven by higher nominal GDP as a result of inflation. However, the level of debt continues to be a risk factor for the economy and the markets, so one of the challenges for 2022 will be to maintain a credible fiscal anchor despite the low expected economic growth and the presidential elections in Q4 2021. We believe that the gross debt will resume its upward trend, closing the year above 85% of GDP.

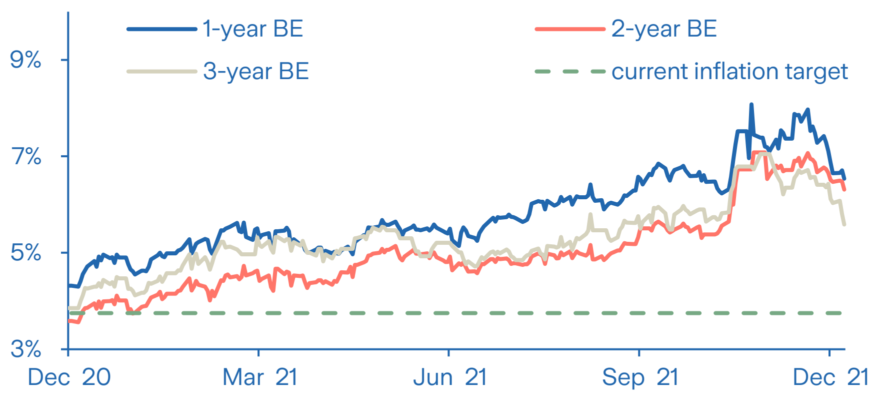
Also, the primary fiscal deficit for 2022 will be larger than that presented in the budget law and similar to that of 2021, but with risks skewed to the upside.

The deteriorating fiscal situation and higher inflation to cause Selic rate to rise

Since the deterioration of the fiscal situation, which increased inflationary pressures and depreciated the exchange rate, the Central Bank of Brazil (BCB) has tried to re-anchor inflation expectations by accelerating monetary tightening, signaling a much higher Selic terminal rate and indicating that inflation risks have increased.

We estimate that the BCB will not compromise its credibility at the expense of economic growth and continue to raise the

Breakeven inflation rises after the announcement more fiscal spending



Source: Bloomberg

Selic rate in the first quarter of 2022, reaching at least 11%. We expect the tightening cycle to stop in Q1 2022 since by then the impact of higher interest rates should have already influenced the pace of inflation, and inflation expectations should likely decline, particularly for the policy horizon. In addition, we expect the higher rate to halt the FX depreciation, which, together with the economic slowdown, should also temper inflation. Thus, considering the impact on economic activity, the BCB may modify its forward guidance in Q4 of 2022 and start to ease.

However, the risks of de-anchoring inflation remain to the upside given the fiscal uncertainty, which may delay the BCB's easing for 2023, increasing the risk of a more significant economic slowdown and a slower pace of convergence to its inflation target.

The high inflation seen during 2021 is largely explained by a number of factors such as a rise in commodity prices and input costs, supply chain disruptions, an exchange rate depreciation, the hydroelectric crisis and services price inflation resulting from the economic re-opening. Although supply driven inflationary pressures may continue in 2022, we expect inflation to ease gradually, reversing its upward trend on the back of weaker economic growth and higher interest rates. Notwithstanding the above, it should remain above the BCB target, closing the year at 4.6%

Politics remains an unknown factor given uncertainty around presidential candidates

The general election of the president, 513 members of the Lower House, 27 out of 81 members of the Senate, 27 state governors and state assembly members for four year terms will be held in October, but the electoral discusions have already started, which is earlier than usual. Everything suggests that the incumbent Jair Bolsonaro and former president Lula have the first option in the presidential election. The appearance of a third candidate who can capture the votes of the centre parties would be a positive surprise for the market and may boost the price of local assets. We believe at least two conditions must be met in order to have a competitive third option.

The first condition is that Bolsonaro's approval rating continues to fall and declines below 20. According to the latest polls, the president's approval rating is at its lowest level since the beginning of the pandemic, reaching the level of 24 in October, compared to 35 in January 2021. This condition is important since there is a high correlation between this and the intention to vote, which would suggest space for a third candidate.

The second condition necessary to be fulfilled in order to have a third competitive candidate is that the number of potential candidates representing the center is reduced in order to prevent what happened in 2018, where there were at least five candidates.

Likewise, if Lula is positioned as the winning candidate, it will be necessary to know whether or not he will modify the fiscal rules that are the anchor to fiscal stability for the coming years. On the other hand, the risk is that a greater drop in the incumbent's surveys could drive higher fiscal spending, which will cause investment sentiment to deteriorate, damaging the price of assets.

The gap between EM and Brazil stocks to narrow, as negativity is largely priced in

Brazil was the worst-performing equity market in LatAm and in the world during 2021 as investor confidence was drained by the deterioration of the fiscal situation, increased political risk and the rise in interest rates.

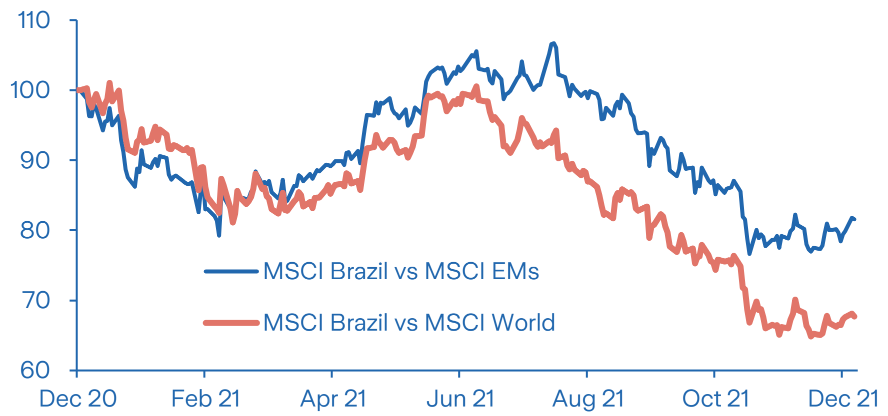
Domestic factors related to the rise in interest rates, more persistent inflation than expected, a more depreciated currency, and the drought have led to a lower GDP forecast for 2022, with some quarters even having the prossibility of negative growth. This scenario of higher interest rates and lower expected growth has increased the risk of corporate earnings disapointing, which undermines the attractive valuations currently. However, considering the level of the MSCI Brazil, we estimate these negative events are already priced in, possibly putting a floor on the equity market at current levels.

Brazil could benefit however, as other markets show more challenging valuations, while the reopening of the economy, supported by a faster-than-expected vaccination process, could provide a positive surprise. Attractive valuations, considering that it trades at a discount versus emerging markets and the higher commodity prices, should also positively impact the market.

Although 2022 should be a volatile year for Brazil, it is important to highlight the resilience of the corporate sector, which has significantly deleveraged over the last few years, with the average net debt/EBITDA declining across all sectors. Also, better corporate earnings and the rally in commodity prices have allowed companies to face these challenging times in better shape and no big bankruptcies are expected.

All in all, we do not see large downside risk in the equity market from currently depressed levels, seeing a potentially good return in the year ahead. However, tactical, selective, and timely strategies will be key to benefit in this volatile market.

Political and policy risk pressured equity market



Source: MSCI, Bloomberg. Note: Indexed to 100 at December 31st, 2020.

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