No trust, no change

Advanced Economies Outlook 2022

Joeri de Wilde

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We believe that 2022 will centre around trust in policymakers. With the economic recovery in advanced economies shifting into lower gear, short and longer-term issues will come into full focus and collide. Supply constraints and longer-than-expected elevated inflation will test the longevity of ultra-loose monetary policies and financial market bubbles. Growing social unrest will challenge governments' COVID-19 policies, asking for plans to address the increase in inequality and huge public debt levels. And the ongoing global warming in the wake of COP26 will pressure authorities to finally translate climate commitments into decisive policy action.

This will all happen against the background of another year of above-potential global expansion in economic activity, supported by the further release of pent-up demand. But policy mistakes can easily disrupt this normalisation process. It is up to policymakers to steer towards a newfound trust in actual change that can catalyse wider sustainability action. Indecisiveness, on the other hand, will merely strengthen the strong feeling that everything will stay the same.

Global economy

Recovery continues on shaky foundations

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For 2021, we project global economic activity to expand by an astonishing 5.7%. Supported by unprecedented monetary and fiscal stimulus and vaccination progress, advanced economies have recovered at record speed from the COVID-induced recession. In the first half of 2021, there was widespread trust that the policy response in advanced economies had set the scene for a goldilocks *reflation* recovery, where a prolonged period of strong economic growth would be accompanied by only a moderate uptick in inflation.

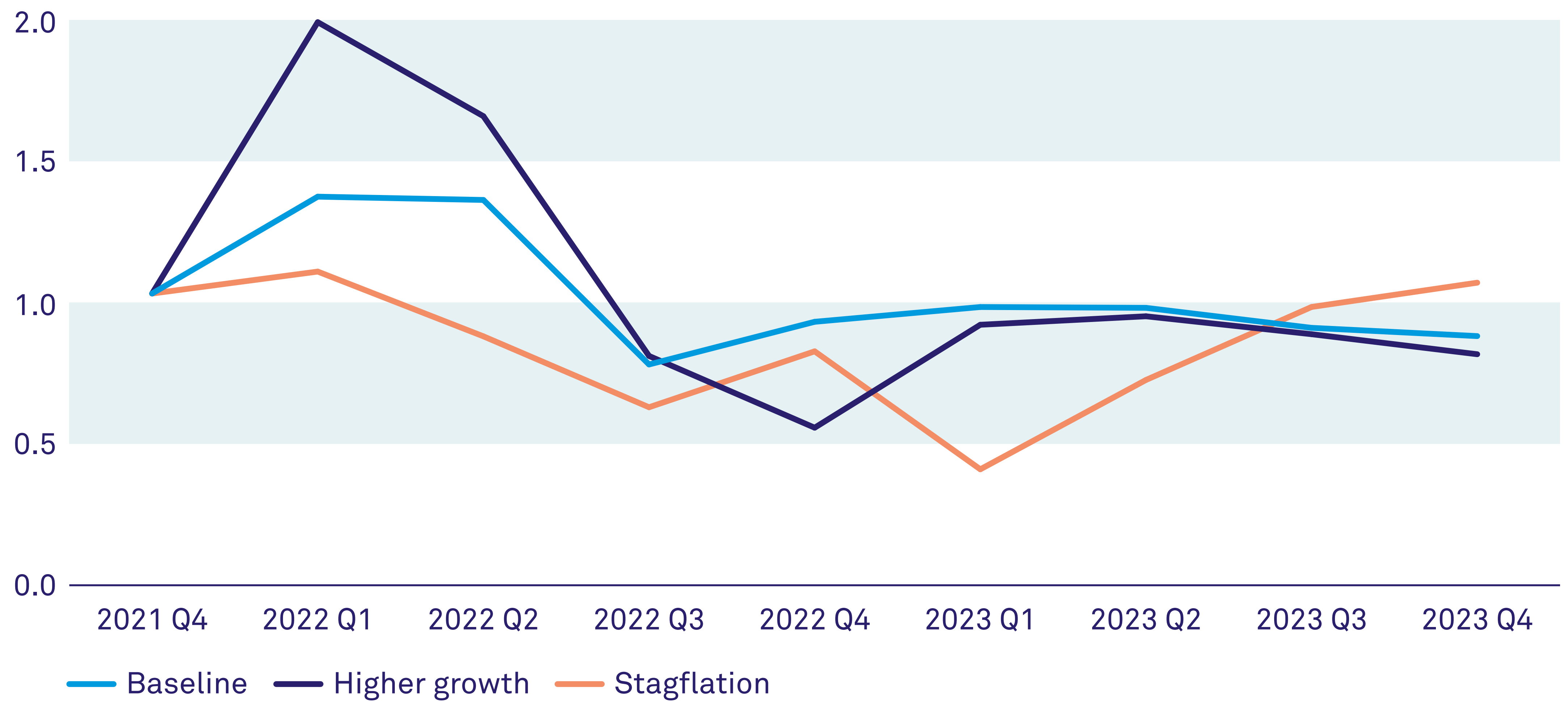
We know now that these expectations were unrealistic. New, more infectious COVID-variants have emerged, and COVID-19 is steadily transforming into an endemic disease. Meanwhile, supply-side constraints have shown that the lockdowns were more disruptive than initially thought. Together with surging commodity prices this has pushed inflation far above previous expectations, while simultaneously slowing the economic growth momentum. As a result, trust in policymakers has been deteriorating since the summer.

Despite straying from the goldilocks recovery path, in our **baseline scenario** we still project an above-potential global economic activity expansion of 4.4% in 2022. This is predicated on our expectations that the loss of trust in policymakers will slow because supply constraints (incl. tight labour markets) will start fading in the course of Q1 and inflation will fall sharply in the second half of the year. Very gradual COVID-19 progress due to regular booster shots and possibly new effective drugs will also slow the deterioration of trust. This sets the scene for continued strong consumption due to pent-up household and corporate demand. In this scenario, monetary and fiscal policies will only tighten slowly.

In our **stagflation scenario**, we project a global economic activity expansion of 3.6% in 2022. Continued COVID-disruptions are accompanied by persistently elevated inflation all throughout 2022 and 2023. This will accelerate the loss of trust in policymakers to facilitate a goldilocks recovery and lead to lower household consumption, business investment and international trade. Monetary policy tightening will happen earlier than in the baseline scenario, as continued peak inflation readings will force policymakers to act. At the end of 2023, the loss in GDP growth compared to the baseline scenario would be 1.7 percentage points.

In our **higher growth scenario**, we project a global economic activity expansion of 5.2% in 2022, as rapidly improving global coordination in the distribution of vaccines, further improving vaccination rates and effective COVID-medicines allow for a complete removal of restrictive measures. This will boost trust in policymakers and future economic prospects, thereby increasing household consumption through a faster normalisation of the savings rates and increased willingness to spend a part (30%) of the excess savings. The fading of supply constraints will in the meantime make sure inflation comes down. In this scenario, monetary and fiscal policies will not significantly differ from the baseline.

Figure 1 Real GDP growth (Q-o-Q %)



Source: NiGEM, Triodos Investment Management

Trust vital for the further release of pent-up demand

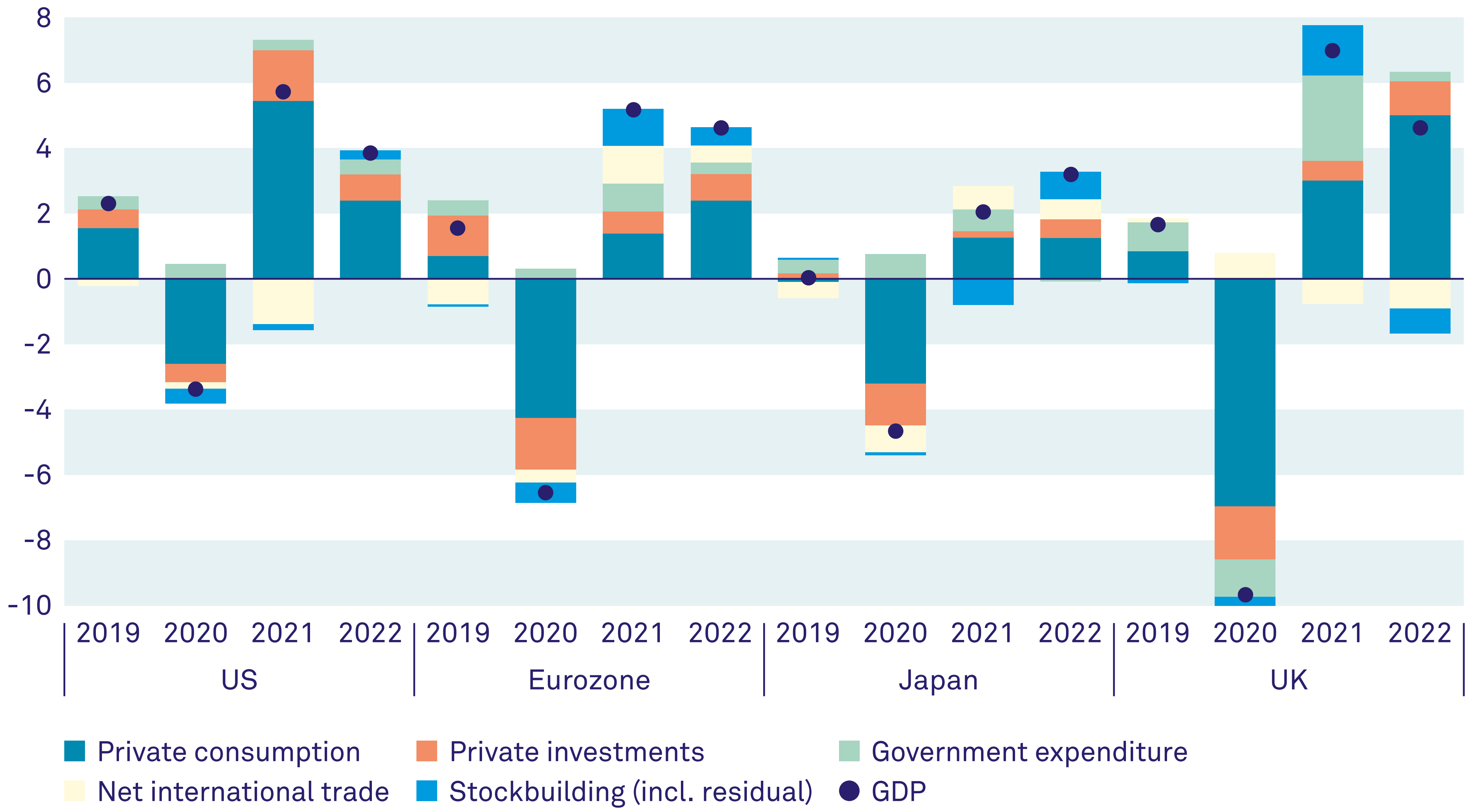
In our baseline scenario, we expect all major advanced economies to experience another year of growth above their long-run averages. Household consumption will by far be the most important driver of this expansion in economic activity (see figure 2). Due to the enormous government income support and labour retention schemes, and the inability to spend during lockdowns (mostly on services), households in all major advanced economies have been able to substantially increase their savings since the start of the pandemic. Accumulated excess savings now stand at approximately 10% of GDP. Moreover, savings rates in most major advanced economies are still elevated compared to pre-pandemic levels. As we expect the loss of trust in policymakers to slow as inflation comes down and supply constraints fade, we foresee that a further normalisation of savings rates and partial spending of the excess savings will lead to continued consumption growth in 2022.

Private investments, which mostly consist of business investments, are the next major contributor to the increase in economic activity in 2022 in the major advanced economies (except Japan, where net trade will be slightly more important). Like households, companies are also full of pent-up demand, as the stock of capital is still unequal to its pre-pandemic trend. Combined with still surging consumer demand and supply bottlenecks, this appears to have spurred capital expenditure plans: forward capital expenditure intentions in the US have surged to the highest level in 20 years, and eurozone capital expenditure intentions have also sharply improved. Actual capital expenditure ultimately depends on trust in the ability of policymakers to correctly assess the danger of persistently elevated inflation and the ability to further reduce the impact of COVID-19 on economic activity.

In our baseline scenario, net trade will again be a drag on growth in the US and especially the UK, with import growth outpacing export growth. The eurozone and Japan will once more benefit from international trade as export growth will outpace growth in imports.

The US economy already reached pre-pandemic levels of activity before summer 2021 and Japan will follow by reaching pre-pandemic activity levels in the final quarter of 2021. In our baseline scenario, we expect the eurozone to reach pre-pandemic levels by the start of 2022, while the UK will only reach pre-pandemic levels at the beginning of Q2 2022. The aggregate output gap for the major advanced economies will turn positive in 2022, although that is mostly due to the US, as the other economies will still have a minor negative output gap.

Figure 2 Yearly GDP growth (%) - expenditure components



Source: NiGEM, Triodos Investment Management

Supply constraints to gradually ease

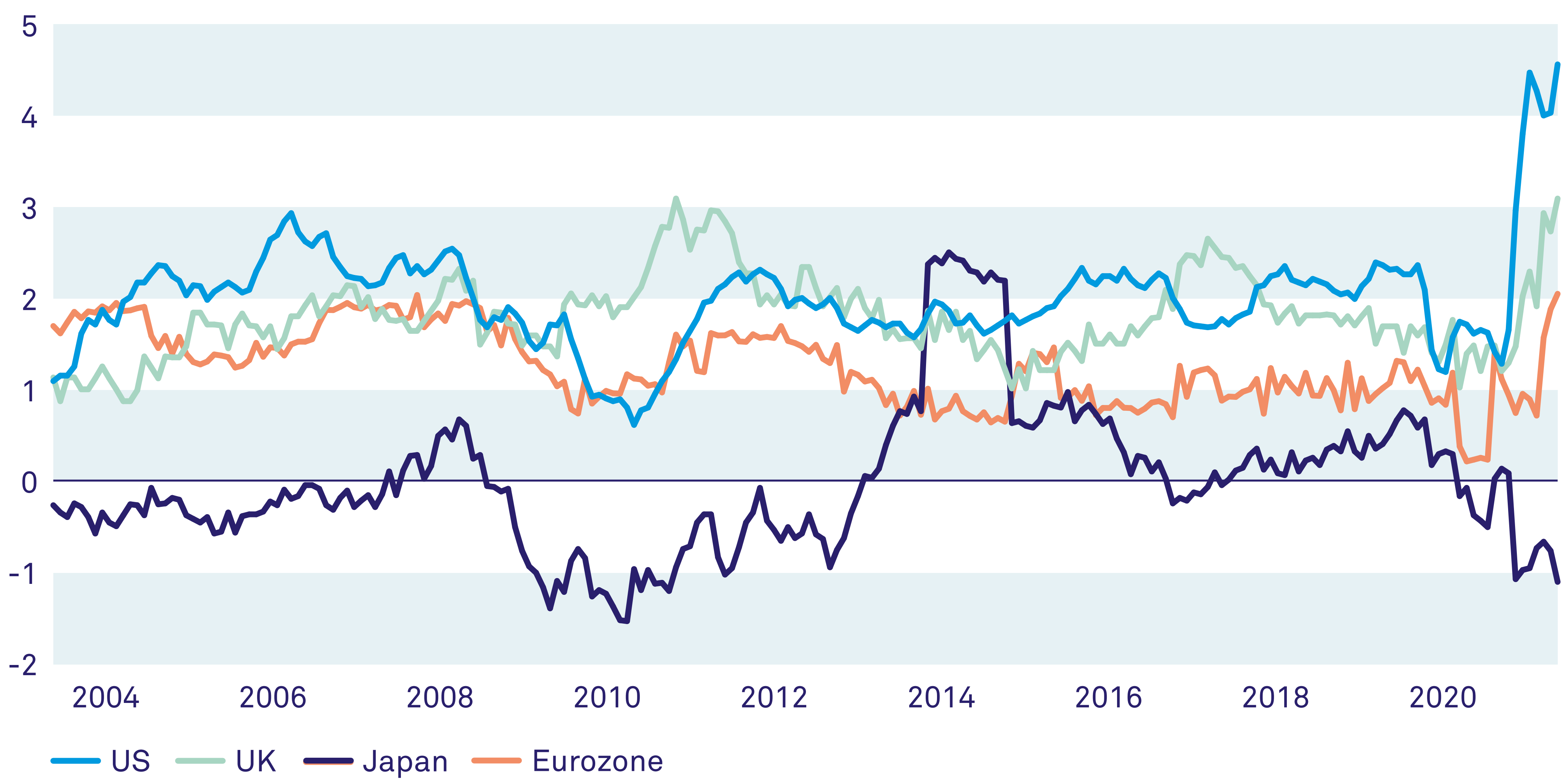
In our baseline scenario, we expect the COVID-induced supply-side constraints to have largely faded by the end of 2022, because ongoing strong business investment should increase capacity as the year proceeds, as should the gradual normalisation of goods production and transportation dynamics. The ending of generous government support schemes should at the same time further normalise the still elevated unemployment rates and depressed labour force participation rates (both apply especially to the US and the UK), while consumers shifting their spending patterns from goods towards services should also alleviate some of the supply chain pressures.

We do expect restrictive measures to continue hampering the supply-side in the coming months in our baseline scenario, because vaccination rates are still low in many parts of the world and winter is approaching in the major advanced economies. In our stagflation scenario, the ongoing COVID-restrictions will mean disrupted supply chains all throughout 2022. The accompanied loss of trust in the abilities of policymakers to get rid of COVID-19 any time soon will at the same time likely increase caution to re-enter the labour market, amplifying the supply constraints. In our higher growth scenario, on the other hand, workers will enter the labour market faster than anticipated, as COVID-19 infections are successfully contained and trust in policymakers increases. In this scenario, restrictions are not necessary anymore early in the year, implying a more rapid easing of supply chain disruptions.

Inflation sticky, but peak pressures to fade

It is by now evident that the sharp rise in inflation in most of the major advanced economies since spring 2021 can't be classified as purely transitory. Base effects resulting from the initial plunge in prices at the start of the COVID-crisis have gradually faded, and inflation is now also clearly visible within core inflation (inflation stripped from volatile food and energy items, see Figure 3). Still, there is divergence within the major advanced economies. The US has by far seen the most substantial price rises, as the enormous fiscal stimulus has triggered a surge in consumption. The UK and the eurozone have also experienced significant price rises, but not to the same extent. Japan, by contrast, still struggles with low inflation rates. When looking at core inflation rates, only the US has significantly surpassed its peak of the past two decades. Overall, we deem the US (enormous stimulus) and the UK (Brexit) to bear the highest risk of persistently elevated inflation.

Figure 3 Global core CPI (twelve-month % changes)



Source: Refinitiv Eikon, Triodos Investment Management

In our baseline scenario, we expect the labour market and commodity prices to be less inflationary in 2022. As explained above, there is still quite some slack in the labour market, which should reduce the current labour shortages. But inflation will still be high in the coming months, eroding household's real disposable income, and shortages will only resolve gradually. We therefore expect workers to demand higher pay. However, in our baseline scenario, we expect the fading of supply constraints to outweigh the price pressures that will result from wage growth.

Similarly, we expect that the most substantial commodity price rises are behind us. Brent oil rose to close to USD 85 per barrel in October 2021, compared to USD 35 a year earlier. Base effects should therefore come into play as 2022 proceeds, making similar annual price increases highly unlikely.

In the end, the key to next year's inflation will be consumer and market inflation expectations. With inflation remaining high for at least the next couple of months, the trust in the abilities of central banks will be the deciding factor making inflation going one way or the other. In our baseline and higher growth scenarios, we expect longer-term inflation expectations to remain anchored, but in our stagflation scenario the waning trust in central bankers will de-anchor longer-term inflation expectations.

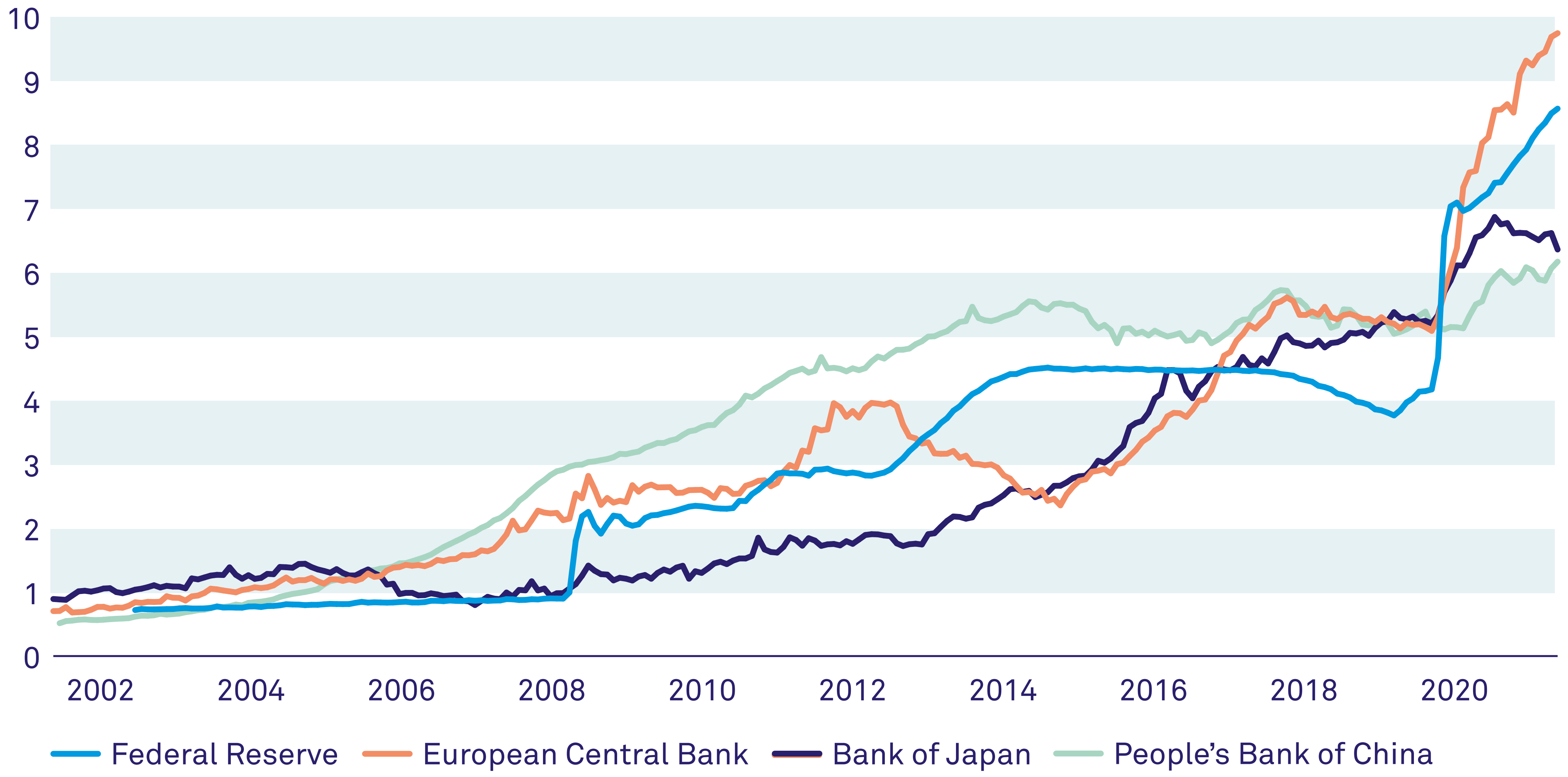
Captives of their own ultra-loose policies

Already before the pandemic, we warned that the excessive monetary stimulus that started during the 2008 global financial crisis would lead to a disconnect between the 'real' economy and financial markets. The ultra-loose policies had failed to push up real economy inflation, leading instead to artificially high (financial) asset prices. Since then, the balance sheets of the Federal Reserve (Fed) and European Central Bank (ECB) have exploded, as they have grown by approximately 100% to reduce the impact of the COVID-induced recession (see Figure 4). Policy interest rates of all major central banks have at the same time been reduced to close to or even below zero. As expected, this has numbed financial and housing markets even more and pushed asset prices even further into record territory.

Elevated inflation readings over the last few months have made markets to price in a first Fed interest rate hike by mid-2022, and an ECB rate hike by end-2022. In our baseline and higher growth scenarios we expect both central banks to be more reluctant, the Fed hiking its policy rate in the final quarter of 2022, and the ECB end 2023. Inflation coming down from its peak will strengthen the trust in central banks, as they rightfully assessed that inflation would be largely transitory. This will keep inflation expectations anchored, which will allow central bankers to stay accommodative for longer, which they will likely do out of fear of hurting the inflated markets. In this sense, they have become captives of their own policies.

We expect the ECB to terminate its Pandemic Emergency Purchase Programme (PEPP) by the end

Figure 4 Major central bank balance sheets - total assets (x 1,000 US billions)



Source: Refinitiv Eikon, Triodos Investment Management

of March 2022 (although it will still reinvest principal payments from maturing securities), but we expect that the bank will temporarily increase its 'regular' asset purchase programme (APP) to above the current EUR 20 billion a month to avoid market turmoil. In our stagflation scenario, however, persistently elevated inflation will decrease the trust in the abilities of central bankers, thereby de-anchoring inflation expectations. Looking at the current levels of inflation, we deem this most likely to happen in the US. Consequently, in our stagflation scenario we expect that the Fed will be forced to hike in line with market expectations, implying a first rate hike mid-2022.

We expect the Bank of Japan to stick to its ultra-loose monetary policy all through 2022 in all three scenarios, as inflation in Japan will remain subdued in all instances. Our expectations for the Bank of England, on the other hand, are equally hawkish in all scenarios, with two more rate hikes in 2022 after the one in December 2021.

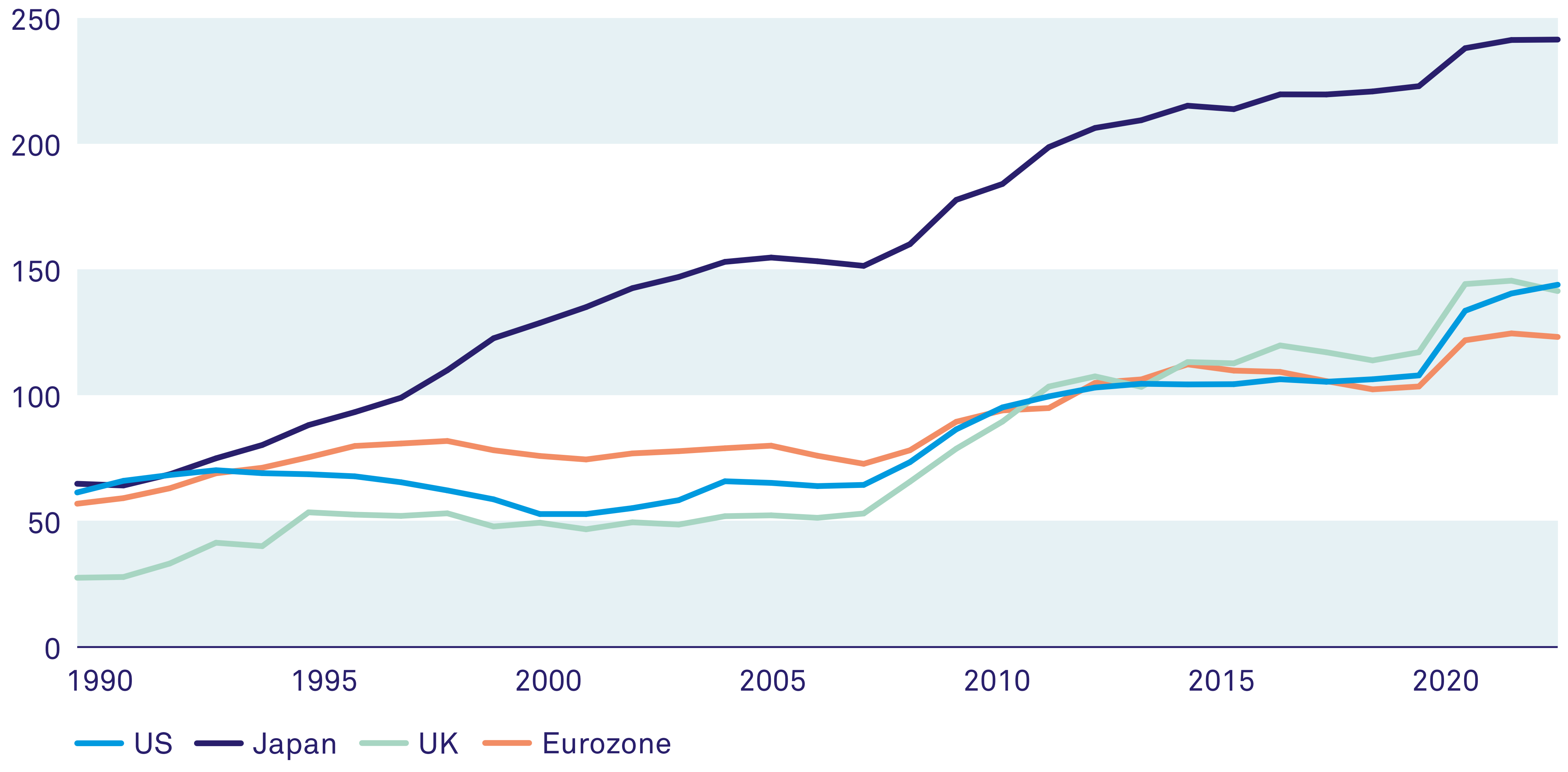
Urgent need for transformative action

In both 2020 and 2021 the governments of advanced economies have done all in their power to support their economies. This enabled swift economic recoveries and prevented more permanent economic scarring but also severely increased public debt levels (see Figure 5). Since last summer, support schemes have ended or have gradually been scaled down, and this process will continue into 2022. Deficits will consequently fall, implying that fiscal impulses will not contribute to economic growth anymore.

Just as with central banks, the level of public trust in government policies determines the likelihood of our three scenarios. This level of trust depends largely on government action on three (related) topics: COVID-19, inequality, and climate change. The higher growth scenario requires governments to convince their citizens they follow the right COVID-strategy. This has already proven to be a daunting task, as the long-term downward trend in institutional trust in advanced economies is now accompanied by waning trust in government institutions' domestic measures to tackle the COVID-crisis. This is closely related to the COVID-induced increase in inequality. A key pillar of the COVID-plans should therefore be the reduction of inequality. Governments should focus on redistribution of wealth through tax reforms, and investment in education and (digital) infrastructure. Small steps in the right direction are the more realistic scenario, however, in line with our baseline scenario, with trust staying above the minimum level required for continued solid economic growth driven by pent-up demand. Failure to contain COVID-19 and its related issues through 2022, resulting in prolonged restrictions and a further loss of trust, would be in line with our stagflation scenario.

Equally important is the need for governments to finally rise to the occasion and translate vague climate pledges into decisive action. This can be a

Figure 5 Public debt (% of GDP, incl. OECD forecast)



Source: Refinitiv Eikon, Triodos Investment Management

strong signal that substantially increases trust in the green transition as the only way forward. The recently concluded United Nations Climate Change Conference (COP26) has shown the goal of limiting global warming to 1.5 degrees Celsius end of century is still alive, yet the targets for 2030 remain **totally inadequate**. This shows there is a credibility gap, as most of the pledges are for emissions reductions only after 2030. This push towards the future of actual climate action erodes trust in a swift green transition, making it less likely that the private sector will step in to fulfil its essential investment role. This failure to implement truly transformative policies aligns with our baseline scenario. To substantially improve trust, public policies in advanced economies should focus on investments in green infrastructure and first-of-a-kind projects to reduce the perceived risks to private investors. 2030 emissions reductions targets should also be further sharpened, and international collaboration intensified, while execution of the plans should start instantly. Failure to act could severely impact trust in future wellbeing through growing concerns about the impact of climate change.

Growth and inflation projections – baseline

	GDP growth (%)			Headline inflation (% avg.)		
	2020	2021	2022	2020	2021	2022
Global	-3.1	5.7	4.4	2.9	4.2	4.2
US	-3.4	5.7	3.8	1.2	4.4	3.5
Eurozone	-6.6	5.2	4.6	0.5	2.4	2.3
UK	-9.7	7.0	4.6	1.7	2.4	3.6
Japan	-4.7	2.0	3.2	0.2	-0.2	0.8
China	2.3	8.0	5.7	2.4	1.1	2.0

Investment outlook 2022

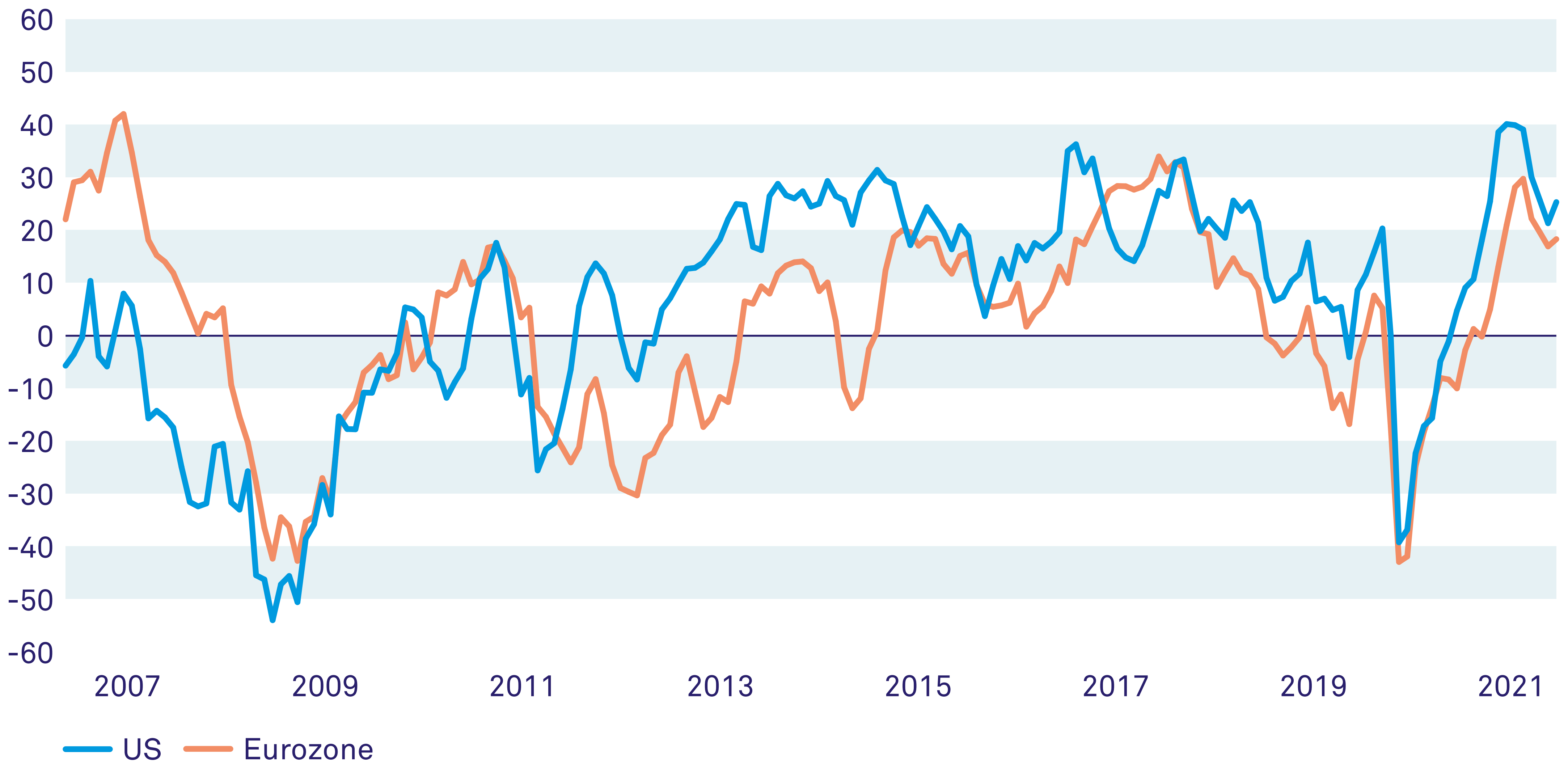
In 2022, investor trust in the major central banks will be decisive for the direction of financial markets. As it stands, equity markets still seem to believe that monetary stimulus will be perpetual, with markets continuing to move further into record territory. Although bond markets have started to question the credibility of the never-ending stimulus fairy tale, yields are still close to historic lows. As 2022 proceeds, we believe that economic and inflation dynamics will force investors to abandon their belief in perpetual monetary stimulus. We therefore maintain our cautious allocation stance, as this change in sentiment is likely to lead to a reversion of the upward trend in financial markets that we have seen over the last few years.

Monetary fairy tale comes to an end

To be clear: in our baseline and higher growth scenarios, we expect most of the major central banks to be more dovish than markets currently expect. The central banks are very aware that financial markets are largely dependent on a continuation of the extremely loose monetary policies, and because of the current size of financial markets compared to the real economy, central bankers will do almost anything to prevent them from coming down. Nevertheless, as economic activity in advanced economies gets closer to its pre-pandemic trend, while labour markets further recover, and inflation continues to overshoot central bank targets in the coming months, it will be hard for central banks to convince investors that they will stick to their guns. The economic situation will increasingly contradict the ultra-loose monetary policy stance. We therefore expect that central banks will at least start to adapt their forward guidance and hint at eventual tightening. Therefore in our baseline scenario, we expect investors to eventually lose trust in the perpetual stimulus fairy tale, even when policies stay accommodative for longer than expected. Consequently, we maintain our cautious allocation stance, as this shattered trust will have serious market implications.

Of course, if we are wrong, and central banks are forced to tighten earlier than we expect because inflation expectations de-anchor (as in our stagflation scenario, or even earlier), rising policy interest rates will also sharply deteriorate investor sentiment and lead to a financial market correction. The current status quo could on the other hand continue for another year, with investor sentiment soothed by continued monetary stimulus all throughout 2022 and the absence of strong forward guidance on tightening.

Figure 6 Investor sentiment



Source: Refinitiv Eikon, Triodos Investment Management

Bond yields will gradually rise

Eurozone government bond yields are still close to historic lows, making eurozone government bonds expensive. At the same time, since the start of 2021 we have seen a period of (modestly) rising longer-term bond yields on the back of rising inflation expectations and a global shift towards monetary tightening, while real yields have fallen further into negative territory. This has been an indication of the bond market starting to doubt the likelihood of perpetual monetary stimulus. The ECB still seems committed, however, to prevent any significant rise in the borrowing costs for governments in 2022, meaning the low yield environment will likely continue for quite some time. We do expect longer-term government bond yields to gradually rise, as forward guidance on the eventual winding down of asset purchase programmes will make investors position themselves more and more for eventual central bank tightening. With respect to eurozone corporate bonds, spreads are still narrow, as strong corporate earnings have positively affected risk sentiment and investors continued their search for yield now that eurozone government bond yields are still low. We expect demand for corporates to stay strong, but nevertheless expect a modest widening of credit spreads as the goldilocks environment for risky assets (strong economic growth and peak monetary stimulus) slowly begins to worsen. Financial difficulties may also still arise further down the road when stimulus measures are being lifted. We therefore remain cautious and prefer high quality names. The threat of a sudden de-anchoring of inflation expectations leading to sharply rising interest rates also makes us confident in our cautious approach. Overall, we remain neutral in bonds.

Equity markets to peak mid-2022 at the latest

Global equity market valuations are still unattractive. The US equity market continues to look expensive, both historically and relative to Europe and Japan, with Japan being cheaper than Europe. As economic growth will gradually normalise and inflation will remain elevated at least in the first half of 2022, we believe revenue and margin pressures will start building. This implies that the period of upward earnings revisions will be left behind, setting the scene for negative earnings surprises, which would warrant lower equity prices. Ultimately, we expect equity investors to come down to earth again by at latest mid-2022, when central bank forward guidance will have shattered their trust in never-ending asset purchase programmes (ECB) and interest rates staying at the zero-lower bound (Fed). Liquidity is expected to deteriorate worldwide due to tapering and steadily hiked official discount rates. Rising inflation expectations resulting in sudden rises in bond yields continue to pose an additional risk to equity markets. Overall, we do not think that the current valuations properly reflect underlying fundamentals and assume that the investor-fabricated central bank fairy tale of never-ending accommodation will come to an end. We therefore remain underweight in equities.

Impact opportunities

We continue to see opportunities in the sustainable investment landscape. The European Green Deal, the EU's roadmap for making its economy sustainable, will continue to gain momentum. The related green taxonomy will enable investors to steer their investments towards more sustainable technologies and businesses, and the creation of an EU Green Bond Standard will deliver a uniform tool to assess green bonds. The recently implemented Sustainable Financial Disclosure Regulation (SFDR), part of the EU's Green Deal, will also make investors more aware of financial risks related to sustainability, and will to some extent limit the options for greenwashing. The Green Deal will also force companies to become more transparent. Besides Europe, we expect to continue to find sustainable investment opportunities in Japan, where corporate governance continues to improve due to top-down governance initiatives while bottom up the Sustainable Development Goals are high on companies' agenda. In the US, there are still interesting pioneers in the smaller company space, though these come at lofty valuations. Overall, we will continue to contribute to the envisioned transition by focussing on investments that support climate mitigation and adaption and the fulfilment of the Sustainable Development Goals in this decade.

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Investing in positive change

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