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Keep an eye on these two risks in 2022

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Highlights

- Our base case for 2022 is one of above-trend global growth and moderating inflation in the major advanced economies, leading to a gradual rise in central bank policy rates.
- We expect this macro backdrop to drive solid earnings growth, while preventing the large compression of equity valuations we would likely see in the case of accelerated rate hikes.
- But we see two key risks to our base case forecast: (1) the entrenchment of persistent inflation due to continued supply shortages and shifting long-term inflation expectations, and (2) a slowdown in growth caused by policy tightening and/or virus uncertainty.
- Either of these risk scenarios could have a material impact on investors' portfolios in 2022. Our models allow us to quantify the expected impact on asset class returns, highlighting the importance of diversification and resilient asset allocation with today's heightened macro risks.

In 2022, we expect growth to remain solid across the globe and inflation to moderate in advanced economies, while staying above central bank targets. Even with new restrictions induced by the Omicron variant, leading economic indicators still suggest positive momentum in advanced economies, likely due to the belief that the current Covid wave will be short-lived. While China's growth slowed in the second half of 2021, fresh stimulus should also help it rebound this year. On the inflation side, the contribution of energy should fade, while investments in supply chain capacity should begin unclogging global bottlenecks in the second half of 2022. But don't expect a whiplash to below-2% inflation: tight conditions in housing and labour markets should maintain inflation above target in the US and Canada in 2022.

These baseline macro conditions – solid growth and moderating inflation – suggest a constructive backdrop for equities this year. Growth in earnings per share is expected to remain solid this year after a sharp increase in 2021, and a gradual tightening in global monetary conditions should help avoid a sharp decline in earnings multiples. But we see two main risks around our base case outlook:

- First, emerging threats to synchronized, above-trend global growth could lead to an unexpected economic slowdown; and
- Second, inflation uncertainty is higher than ever, with risks tilted to the upside, potentially leading to a persistent inflation breakout scenario.

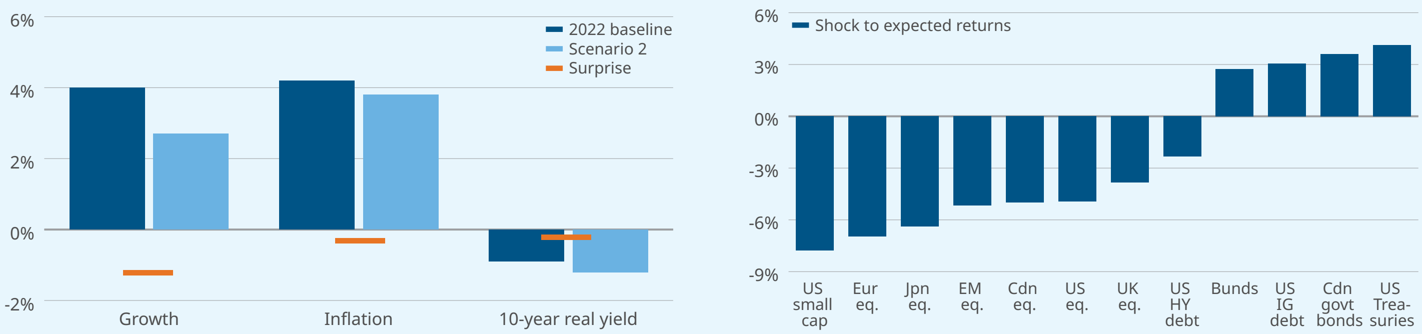
Either of these risk scenarios, should one materialize in 2022, would have material impacts on Canadian investors' investment portfolios.

Figure 1 shows how returns in 2022 could be impacted by a hypothetical global growth slowdown this year. There are a number of looming potential sources of economic weakness. First, the new Omicron variant's impact on global economies could be longer-lasting than markets expect, in addition to the possibility of the emergence of additional Covid variants. Other potential catalysts of a global growth slowdown include the 2022 US "fiscal cliff" effect – that is, the upcoming drop in the US government's contribution to growth – which will be one of the largest in history. US consumers' propensity to spend from savings will be tested, and if households turn out to be more skittish than expected on spending, aggregate demand could slump. As a result, growth could end up lower than the average economist's forecast of about 4.0% for the US in 2022. The shock of a growth slowdown would typically be negative for equity markets, with small cap stocks getting hit the hardest relative to their long-term expected returns. On the other hand, the diversifying power of long-term sovereign bonds shines brightest in scenarios with negative demand shocks, and the net impact on a benchmark 60/40 portfolio would be limited to around -1% based on our model estimates.

Figure 1. A growth slowdown would hurt stocks, but sovereign bonds would shine

Growth slowdown scenario: baseline vs. shock

Deviation from long-term expected returns



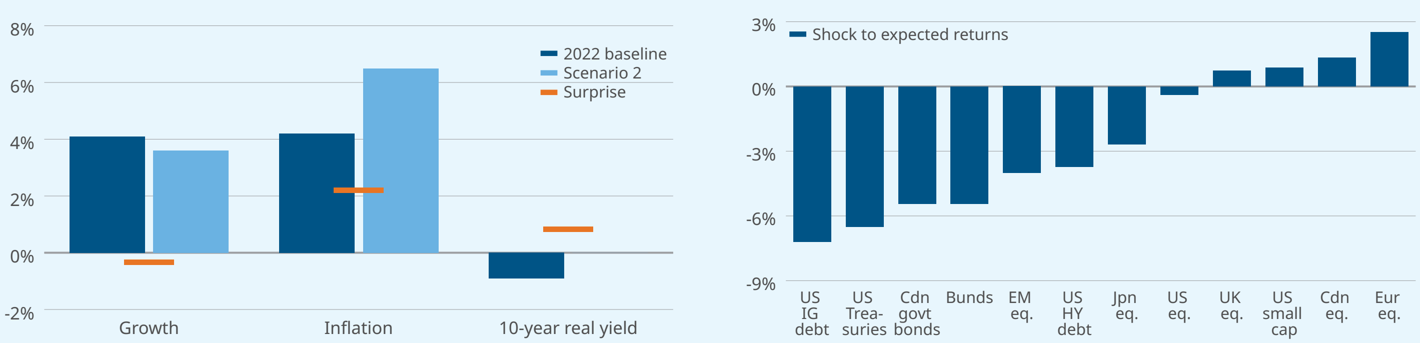
Notes: Risk scenarios calibrated using Oxford Economics' Global Economic Model (Oct-21 vintage) and represent shocks to the consensus value of 2022 macro variables. Baselines for macro indicators in the figure on the left are (1) 2022 consensus annual US GDP growth from Consensus Economics, (2) 2022 consensus annual US CPI growth from Consensus Economics and (3) market-implied one-year-ahead 10-year real yield. The bars on the right-hand charts represent our model view of the scenario returns relative to unconditional expected returns. See Mackenzie's 2022 Orange Book for our unconditional forecasts.

Alternatively, an inflationary shock in 2022 could lead to lower real returns for all asset classes (Figure 2). While most economists expect a progressive moderation of inflation in advanced economies, inflation could surprise to the upside if transportation capacity remains constrained, consumers continue spending disproportionately on goods rather than services and global central banks delay rate hikes for too long. In that hypothetical scenario, US inflation would overshoot the 4.2% consensus forecast, and real bond yields would likely rise. This would be a negative shock for all fixed income assets as well as interest rate-sensitive equities in Japan and the US (e.g., stocks with a growth style tilt). European and Canadian equities would fare relatively better given the larger weight of energy and financial firms in their indices.

Figure 2. An inflationary shock would be negative for fixed income asset classes

Growth slowdown scenario: baseline vs. shock

Deviation from long-term expected returns



Modelling the impact of our main 2022 risk scenarios highlights the importance of holding a well-diversified portfolio across asset classes and geographies. The response of asset returns to different macro risk scenarios varies depending on the nature of the shock. Changes in major macro variables like long-term interest rates, economic growth and inflation are difficult to predict with high conviction. Stress-testing your asset allocation to possible future macro scenarios can be useful to understand potential impacts on portfolios if a macroeconomic shock occurred. In this way, investors can aim for a more resilient asset allocation across different economic environments.

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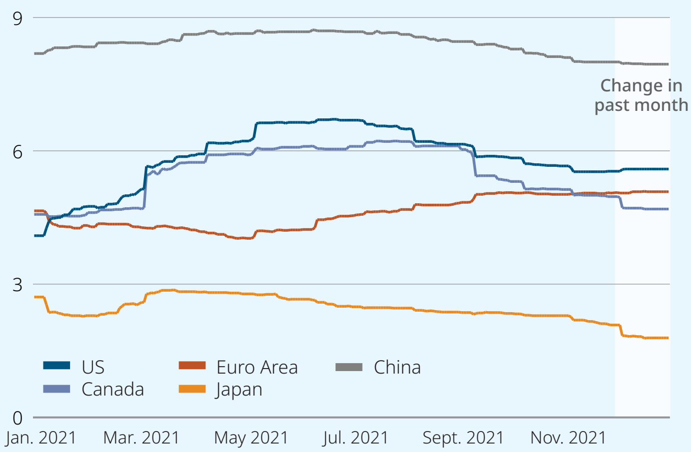
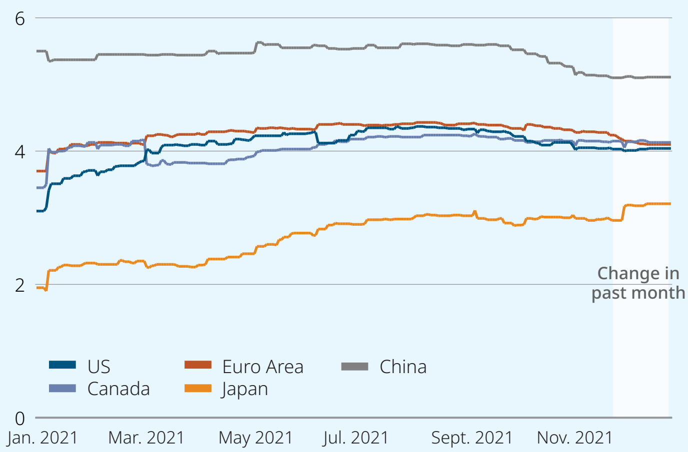
Global macro update

- Our **growth expectations** for this year are broadly in line with consensus. The average economist expects 2022 GDP growth of 4.1% in Canada and 4.0% in the US, both solidly above trend. In addition to the growth risks highlighted in the pages above – Covid uncertainty, fiscal and monetary tightening – which are common to both Canada and the US, the two countries face unique risks. In Canada, growth is especially sensitive to a slowdown in housing: residential investment currently makes up 9.2% of Canadian GDP, compared to 4.3% in the US and to a 2010-2020 average of 7.2%. Housing starts were still very solid in November, but anything more than a gentle decline in residential investment would threaten 2022 growth. In the US, the big question for growth (and inflation) is whether sidelined working-age Americans will rejoin the job market. At 61.8%, the US participation rate is still well below pre-pandemic levels.
- On the **inflation** front, consensus is for 4.0% in the US and 3.3% in Canada in 2022. Expect a tale of two halves: core inflation should stay elevated in the first months of the year, before slowly moderating in the second half.

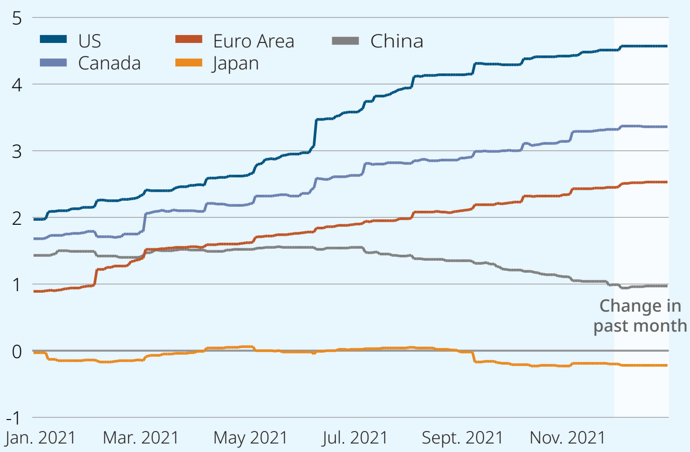
2021 real GDP growth forecast (%, consensus)



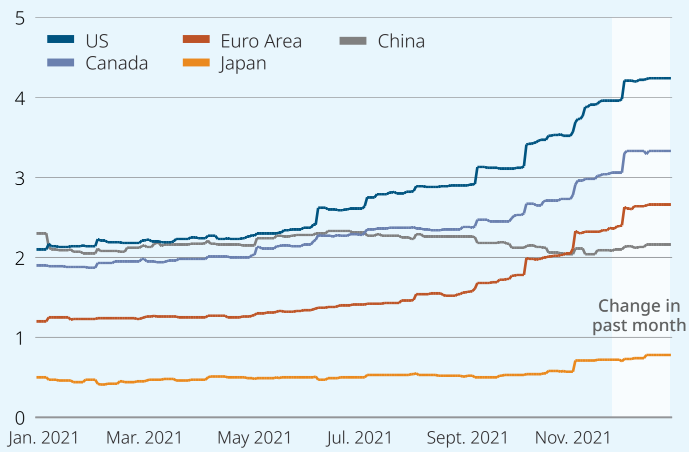
2022 real GDP growth forecast (%, consensus)



2021 inflation forecast (%, consensus)



2022 inflation forecast (%, consensus)



Notes: Forecasts from Consensus Economics as of December 31, 2021.

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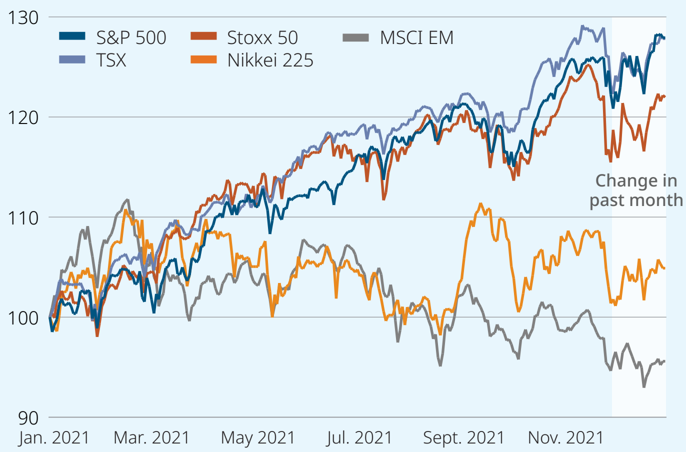
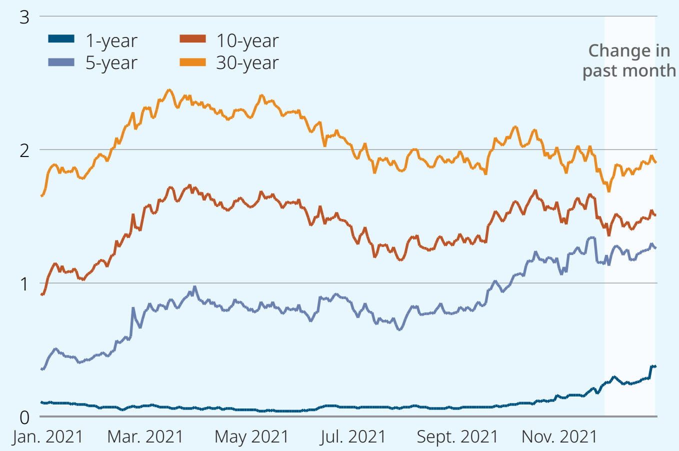
Capital markets update

- **Global equities** were especially volatile last month: the realized volatility of the S&P 500, TSX and Eurostoxx indices were higher in December than in any other month of 2021. A combination of Omicron news and an eventful Federal Reserve meeting drove large daily swings in markets.
- December caped off a solid year for **Canadian stocks**. Energy and financial stocks led the way as commodity prices surged, long-term interest rates climbed and strong demand for residential mortgages carried over from the second half of 2020.
- The **Chinese yuan** continued on the appreciating trend we warned about in our November commentary. Slumping domestic demand caused in part by uncertainty in the real estate market weighed on imports while exports kept growing, resulting in a record dollar trade surplus. The People's Bank of China began to stimulate demand by encouraging lending by state banks and cutting its reserve requirement ratio, which might have contributed to rebounding imports in November. This sets up an interesting dynamic for 2022: China is embarking on a policy easing cycle at the same time the US and other advanced economies are beginning to tighten financial conditions.

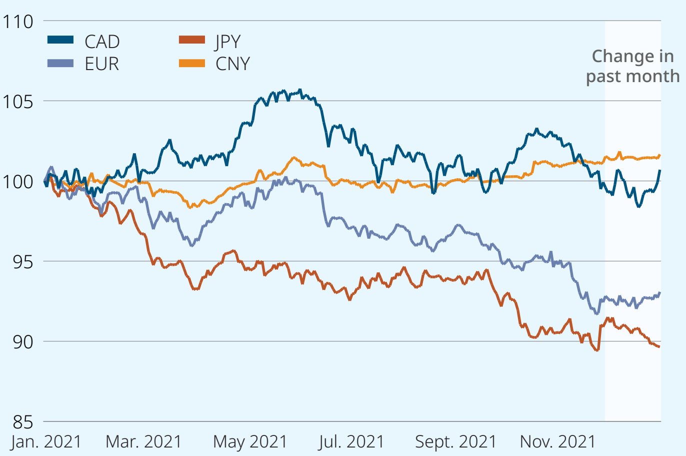
Equity indices (one year ago=100)



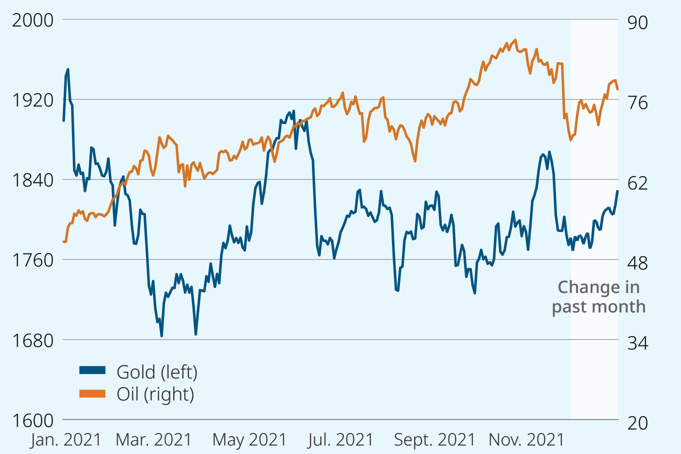
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD)



Notes: Financial data from Bloomberg as of December 31, 2021. Total return equity indices are in local currencies, except MSCI EM, which is priced in USD.

What we'll be watching in January

January 12: US Consumer Price Index release

- The December US CPI inflation print could see the first decrease in year-on-year inflation since August, as the index begins to reflect lower energy prices.
- While the Federal Reserve has retired "transitory" from its vocabulary, it still implicitly expects inflation to moderate significantly over the next quarters. A further rise would likely force it to pull forward its initial rate hike to March, as soon as tapering is completed, something a few Fed officials have advocated for in the past weeks.

January 17: Bank of Canada policy decision

- The Bank of Canada walks into 2022 on a tightrope. Armed with a slightly-tweaked mandate, it must balance above-target inflation with the destabilizing effect of new Covid restrictions.
- Markets are pricing in a greater-than-50% chance that the Bank of Canada hikes its policy rate at its January meeting. A decision to hike rates just a few weeks after the government of Canada expanded a benefit program for furloughed workers would be surprising in our view, though not impossible.

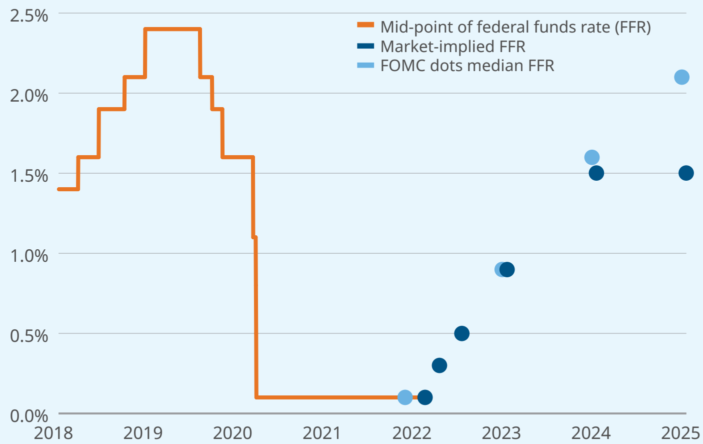
January 19: Teranet/National Bank Home Price Index release

- House prices, home sales and mortgage initiations had been slowing since the peak of housing activity around July 2021. But price and sales data perked up in November, just after the Bank of Canada and other central banks pivoted towards earlier rate hikes. We could be witnessing a "last chance" rally, as buyers anticipate rate hikes and move quickly to lock in lower mortgage rates.

Emerging theme

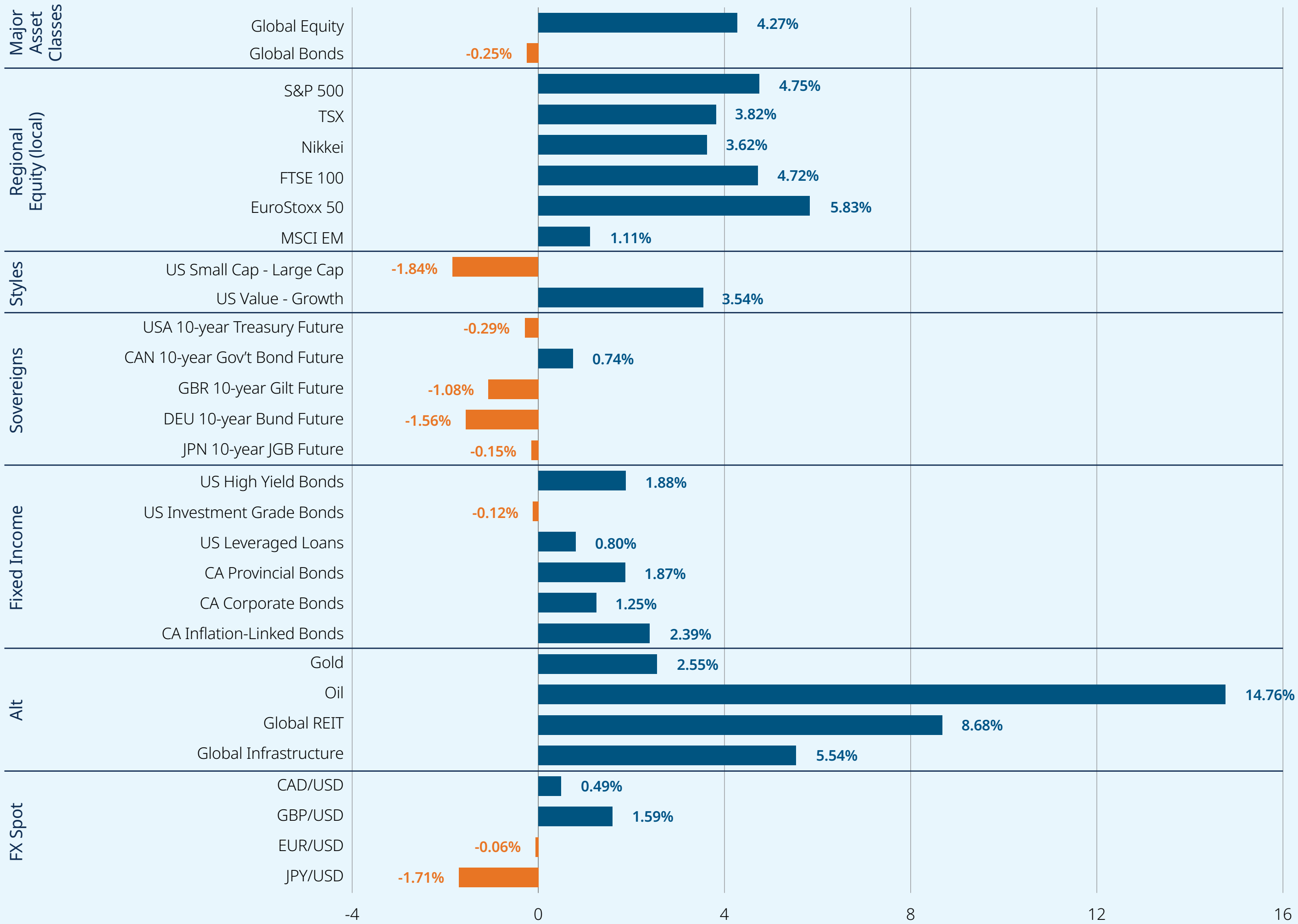
- At its December policy-setting meeting, the Federal Reserve published its new "dot plot", which shows Federal Reserve officials' expectations for the Fed's policy rate.
- Fed officials are mostly aligned with the market's implied expectations over the short term. Both "markets" and officials expect short rates to be between 75bps and 100bps at the end of 2022.
- But there is a large discrepancy over the long term. Fed officials foresee policy rates above 2% at the end of 2024, while futures prices imply rates stagnating below 1.5%. One interpretation is that markets anticipate a "policy error" from the Fed. They see it raising rates too quickly in the next quarters, choking off the recovery and forcing it to pause before having completed policy normalization. A second interpretation is that market's estimate of the neutral rate – the rate above which monetary policy becomes contractionary – is lower than the Fed's estimate. Whichever is the correct interpretation, as long as markets expect the "world's central bank" to keep its rate below 1.5% over the next few years, it is hard to foresee long-term sovereign bond yields surging.

Federal Reserve policy rate expectations



Notes: Via Bloomberg as of December 31, 2021. Market-implied rates are derived from fed fund futures prices.

Capital market returns in December



Notes: Market data from Bloomberg as of December 31, 2021. Index returns are for the period: 2021-11-30 to 2021-12-31. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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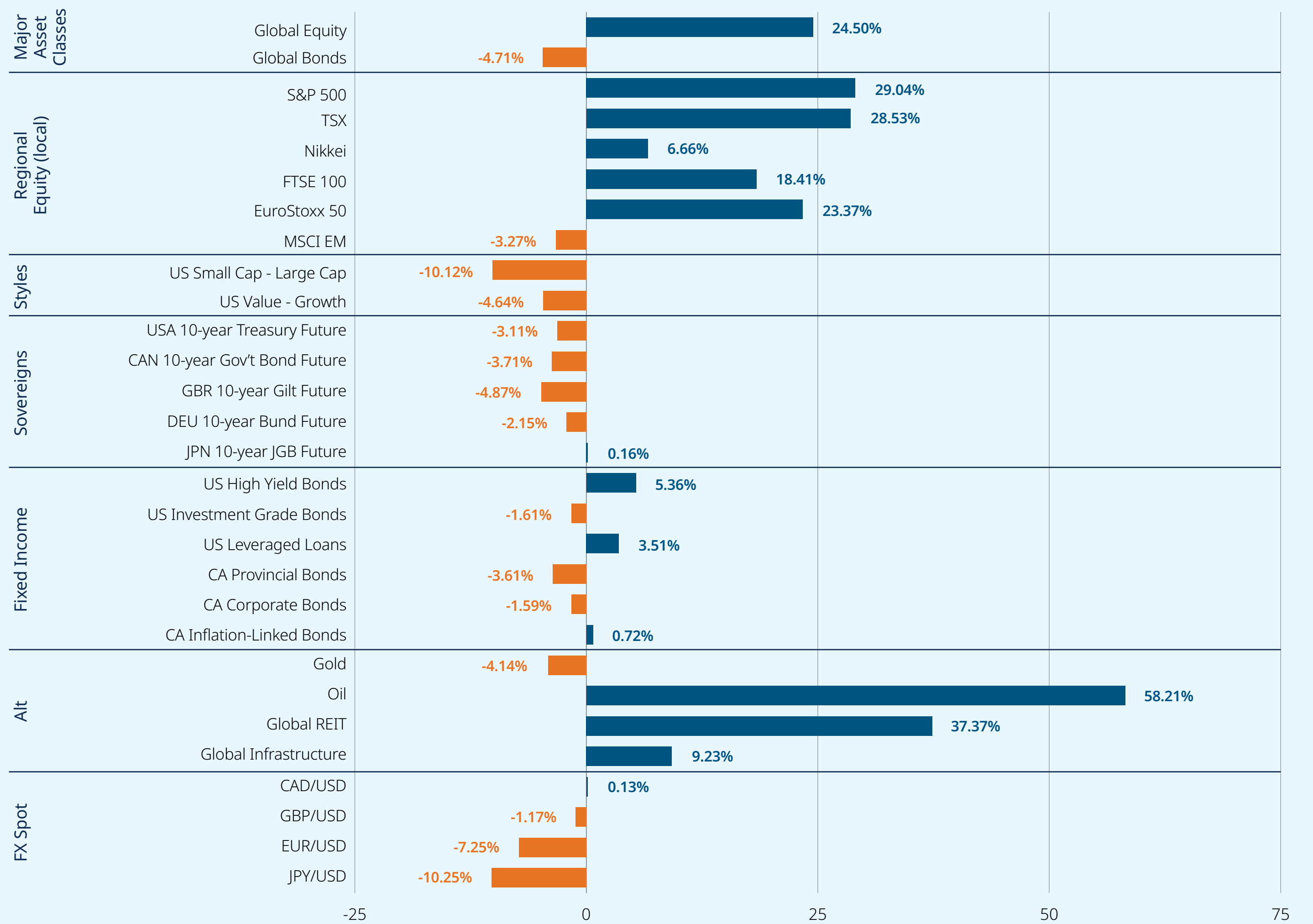
Capital market returns in 2021



Notes: Market data from Bloomberg as of December 31, 2021. Index returns are for the period: 2020-12-31 to 2021-12-31. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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