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Daily Observations
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Our Market and Economic Observations Heading into 2022

A group of our senior investors share their forward-looking thoughts on the year ahead.

On Tuesday, we shared our senior investors' reflections on what surprised them about markets and economies in 2021. Today, we're sharing their forward-looking thoughts for 2022 and the big themes and dynamics they're going to be monitoring closely in the new year. We see this piece as more informal and personal than most of our *Observations*, and the thoughts expressed may not all be fully internally hashed out yet or fully consistent with our systemized views. These thoughts and questions are often starting points for our ongoing research. Lastly, keep in mind that our investment process relies more on adapting to conditions as they evolve than on predicting them.

We also encourage our readers to share their observations and questions about 2022 using the "Give Feedback" button so we can cover those topics in future *Observations.*

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Rates team head Larry Cofsky on the fading effect of central banks and governments on markets: 2022 is likely to be a year when a lot of the things we have gotten used to in the pandemic begin to reverse. After largely doing whatever amount of stimulus they wanted for the past 18 months or so, central banks and governments are beginning to run up against constraints. I think this will force them to pull back faster and stronger than we have thus far experienced and more than consensus and markets expect. Inflation is quickly becoming a problem, not just for central banks but also for governments. Note how Biden's Build Back Better agenda has become quite a political struggle, in part due to inflation concerns. And this building inflation problem means pulling back more is likely to be seen as the better answer to every problem (in contrast to most of 2021, when everyone wanted to err on the side of more accommodation).

This faster pullback by central banks and governments will mean that prices will begin to reflect private sector, not public sector, incentives. As QE rolls off, rates will rise unless this demand is replaced by other players who think bonds are a good deal at record-low real yields in the midst of rising inflation. Current pricing could make sense if the pullback and limited tightening by central banks cause the economy to crack, and quickly; that is the big risk to higher bond yields and that is what it took to kill prior recoveries. But that scenario seems pretty unlikely to me, because huge fiscal stimulus and transfers have created the strongest private sector balance sheets I have seen in a long time, and the economic momentum built up is already the strongest in decades. Historically, economic momentum like we have now is not as easy to slow as current discounting suggests.

Macro team head Jason Rotenberg on how much tightening will be needed and the future of the pandemic: The US economy has reached the stage where ongoing stimulative conditions produce more inflation and less growth. Inflation looks sticky, with rising wages and spending reinforcing each other. Some supply-chain issues are likely to fade, but wage growth and rents will keep inflation high. While inflation and how the Fed reacts to it will likely be the main macro story, the economy is tight and likely to grow moderately. Private sector balance sheets have healed enough to make them more resilient to tightening (i.e., 2022 is not 2018), and yet not much tightening is priced in. The yield curve is priced to get flat at very low levels, and I think a bond short seems like the most direct way to bet on some combination of more inflation, more Fed tightening than is discounted, and a resilient economy.

The main risk to this scenario and this bet is a more aggressive tightening that cracks the equity market or some other exogenous economic shock. The sensitivity of assets to a tightening is bigger than the sensitivity of the economy. I like the idea of pairing a bond short with a more moderate short of the frothier segments of the US economy as liquidity gets pulled back. There is no law against keeping a bet that I have gotten wrong two years in a row, and it seems like better timing now that the Fed tightening will be an additional headwind to frothy stocks, which are conceptually longer-duration (i.e., most earnings are far in the future).

Two other dynamics I will be watching closely are China's economy and the evolution of COVID. Over the last 18 months we saw markets and economies grow increasingly resilient to virus-driven shocks, with responses growing smaller in successive waves. Barring a highly lethal mutation, the pandemic will become a much smaller market driver. How China deals with Omicron's increased ability to spread and an eventual reopening is one interesting question for 2022. In terms of economic outcomes, China probably hasn't eased enough to get the outcomes it wants, but as a result it is now moving toward an additional easing. This is a bullish setup for Chinese assets broadly. I like the short rate long best (there is nothing priced in) and the bond long as well, even if this is not China's preferred way to ease. A stabilization of the Chinese economy will be a tailwind to global commodities in a positive economic backdrop (strong growth, higher inflation, and low capex). Commodity equities are out of favor, trade at high mid-cycle free cash flow yields, and have solid balance sheets. I like the equities more than the underlying commodities.

FX team head Phil Salinger on the potential for monetary divergences to drive currency moves: We are at the stage of the recovery where monetary policies are likely to go from synchronous to divergent, as high inflation in some countries will force tightening well in advance of others. When that divergence manifests more clearly, it should be reflected in exchange rates à la 2012-15, when the US and the UK shifted away from easing and Japan and Europe shifted to more easing. Some important questions for the next year will be how far behind the curve the US stays and whether the US fiscal drag, COVID, or a strong Chinese recovery cause a convergence in economic outcomes without monetary tightening. More medium term, the dollar has gotten expensive, and the world is in search of more production capacity. It would make sense for that combination to result in renewed investment in the emerging world for the first time since 2015.

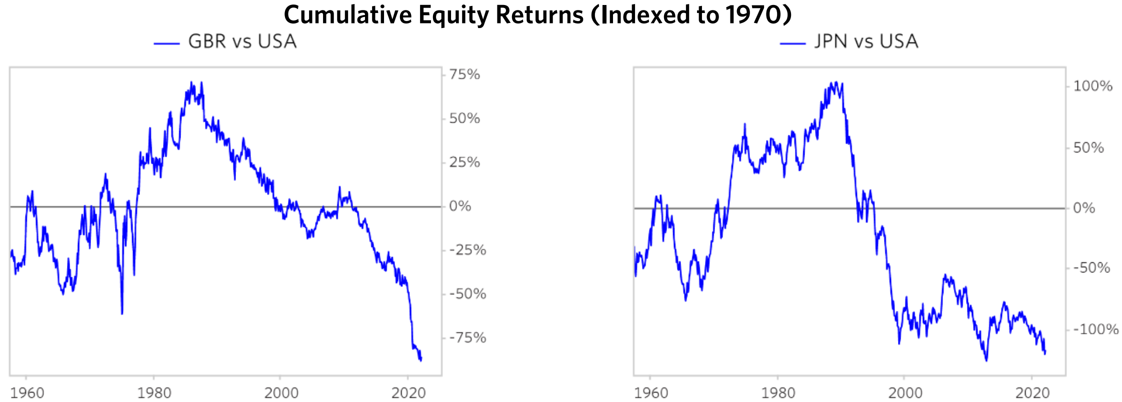
Director of Investment Research Rebecca Patterson on a China recovery: As I think about any future period for markets, I always start with four high-level macro forces: growth, inflation, liquidity, and policy. I see risks across all four in the year ahead, but what I am watching most is growth, given what is priced in when I scan across markets globally. In particular, will we see a narrowing of the growth gap between the US and the rest of the world, and between developed and emerging economies? While not the only thing that matters, China's path will be critical to answering both of these questions.

A China that stimulates relatively more, offsetting a continued property deleveraging and ultimately lifting GDP growth back up toward 5% or higher, will likely flow through to support a number of economies reliant on Chinese trade and consumption, as well as economies reliant on commodity prices, with the latter likely to benefit from improved Chinese demand. That scenario, with strengthening, broadening global growth and well-supported commodity prices, could lead capital out of what we see as concentrated US allocations into much more attractively valued markets overseas, putting a lid on dollar strength in turn. While I would not assume that China will be able to manage these policy goals smoothly over the short term, I think the odds of at least a directionally positive outcome are compelling relative to what's currently priced in for many of these non-US markets, especially equities. That leaves me wanting to enter 2022 with substantial geographic diversification across global equity markets and expecting more of a range-bound dollar versus what we saw in 2021 (with the dollar up against most major and emerging peers).

Equity team co-heads Atul Narayan and Erin Miles on other equity markets catching up with the US: Looking ahead, it feels that things are primed for the equity markets that have lagged the US (China, Japan, the UK, Europe, etc.) to catch up. There are several factors at play. First, COVID has been a material relative support to US equities from all channels—favorable sector tilt, less virus economic impact, more support from falling rates (versus, say, Japan, where yields are pegged), and compressing risk premiums, given safe-haven appeal for US equities, especially the FAANMGs. We would expect the COVID impact to gradually fade in the coming year and this to be a relative support for the markets outside the US.

Second, China is showing early signs of moving toward easing after a year when the structural goals (deleveraging, rebalancing, common prosperity, etc.) were prioritized. This again will be a bigger relative support for economies like Japan, Europe, and EMs that are a lot more exposed to China. Finally, if you look back over the last 100 years, it's almost always been the case that the winners of a given decade end up being laggards in the next one because of the degree of exuberance (and pessimism) that gets priced in following the winning (and losing) stretch. Given how stretched the relative positioning and pricing is today (for logical reasons), we expect the US versus rest of world diff to finally start to revert after a decade-long off-the-charts performance. The main things we are watching closely are the evolution of COVID globally, China's policy stance, and the retail flows in the US, which were the biggest support for US equities over the past year and a half.

Cumulative Equity Returns (Indexed to 1970)



Co-CIO for Sustainability Karen Karniol-Tambour on how the green energy transition will affect economies and markets: How will the world go about addressing climate change in 2022, and what market implications will ensue as a result? The task ahead to transition the global economy away from emitting carbon is enormous. Previous energy transitions tended to be energy additions that unfolded over long periods of time; the green energy transition is meant to replace old energy sources with new ones and happen rapidly, changing the world's energy base in about 30 years. Nothing like this has ever been done before. What matters most for markets is not just whether we will successfully transition and curb further global warming, but also *how* the transition will occur.

Mechanisms for the transition can be more or less inflationary, more planned or more emergent/chaotic. Big market moves will result. As I look ahead, I see governments as mostly lagging and the private sector barreling ahead, leading to large imbalances. The clearest indications are in commodity markets. It will only get increasingly expensive for developed world oil and gas producers to get access to capital as private investors shy away from increasing their exposure to the sector and make "net zero" commitments. And yet, there is not nearly enough energy supply to meet demand, as renewables simply cannot keep up with the roaring global economy. As the private sector moves to gradually transition away from carbon-intensive energy sources, it will need a massive amount of other commodities like iron, copper, and nickel to build the renewable power grid and build charging stations and electric vehicles, etc.—and the supply for these will lag, taking years to come online as well.

Co-CIO for Sustainability Carsten Stendevad on the future of ESG data: Various new reporting regulations and transparency initiatives should help increase the consistency of ESG data. We're carefully watching which behaviors shift as a result of these changes and how these will affect capital flows and economies—in particular, standardized reporting could produce much larger and more coordinated capital flows. Still, standardized reporting will not eliminate the need for investors to build out their sustainability assessments, particularly as it pertains to forward-looking improvements where commitments and current actions necessarily precede sustainability results.