GENERALI INVESTMENTS

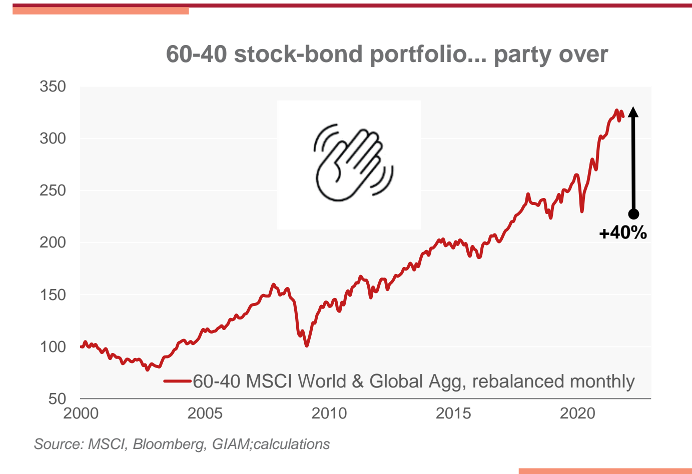
Outlook 2022

Bye-bye beta

December 16, 2021

Our Annual Outlook provides our key views and investment implications for the coming year

- **A fifth global wave rises as we enter the third year of the pandemic, yet we retain a positive view on the economic recovery. The tail risk of a dangerous variant remains, as vaccines have not been a circuit breaker; but they have successfully reduced the risk of severe cases. New drugs are also on the way, and we assume our social and economic lives will slowly normalise in 2022. This recovery has legs, namely consumer spending and capex.**
- **A global 60-40 portfolio has delivered near 40% since the lows of March 2020 – thank you policy makers! Yet the (cautious) policy support removal and stretched valuation will dramatically cut future (beta) returns. The diversification benefit is also set to fall as policy normalises. On average volatility will be significantly higher in 2022 than 2021, as central bankers navigate between tackling inflation and keeping financial conditions in check.**
- **The market is mispricing the Fed's terminal rates; risks are skewed towards more hawkish policy. We expect long-dated bond yields to rise, yet debt sustainability and financial stability risks will cap them. Credit will beat risk-free bonds again: corporate fundamentals are solid, the recovery goes on, and the drawdown risk in IG (a policy tool) is now lower. We predict positive, yet lower and more volatile equity returns. We barbell Value and Defensive Growth.**
- **What could go wrong? The three main risks lie in a policy mistake causing financial havoc, a disorderly energy transition seeing a surge in selected commodity prices and a nasty variant escaping vaccine protection. Those risks demand a nimble approach in 2022: TAA, hedging and alpha generation are becoming ever more important.**



Source: MSCI, Bloomberg, GIAM;calculations

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GLOBAL VIEW – BYE-BYE BETA

Vincent Chaigneau

- **A fifth global wave rises as we enter the third year of the pandemic, yet we retain a positive view on the economic recovery. The tail risk of a dangerous variant remains, as vaccines have not been a circuit breaker; but they have successfully reduced the risk of severe cases. New drugs are also on the way, and we assume our social and economic lives will slowly normalise in 2022. This recovery has legs, namely consumer spending and capex.**
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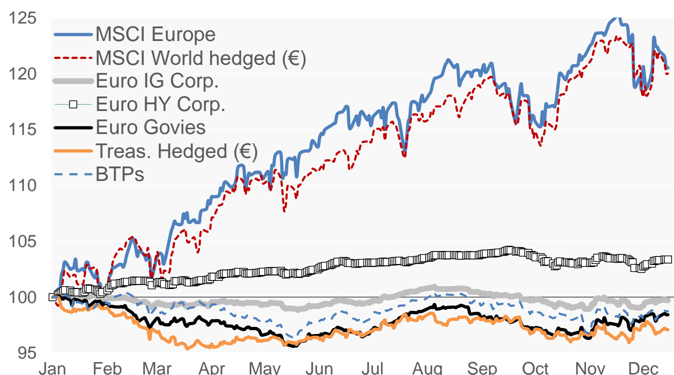
The key question, as we enter 2022, is whether the surge in inflation that has come with the policy-induced recovery, will prove sticky or not. Partly, we think.

The end of beta. We went into 2021 with confidence about the economic recovery and financial returns ("2021 Outlook: Repair and despair"). Global growth beat our optimistic expectations (likely 5.8% vs. 5.2% expected), and so did equity markets: MSCI Europe and World (hedged) have delivered some 20% YTD. The ranking of returns was not so surprising, with equities beating Fixed Income, spread risk (High Yield) delivering more than duration risk, and IG outperforming Govies. A 60-40 global stock-bond portfolio (rebalanced monthly) has delivered a return of +40% since the lows of March 2020. This feast has concluded a remarkable run in the aftermath of the Great Financial Crisis. It has been a great dozen of years indeed. At these levels of valuation, investors shall now prepare for muted returns, as we found in the annual update of our 5-year total return forecasts. Central banks have greatly contributed to the party. The balance sheet of the G4 central banks (Fed, ECB, BoJ, BoE) has grown from 35% of GDP before the pandemic to near 60%. We are talking about economies that together make about $45tn. The key question, as we enter 2022, is whether the surge in inflation that has come with the policy-induced recovery, will prove sticky or not. Partly, we think. And more so that the recovery has legs, with consumer spending and capex likely to keep the cycle going for longer.

Year-to-date total return (€)



Source: Bloomberg, GIAM

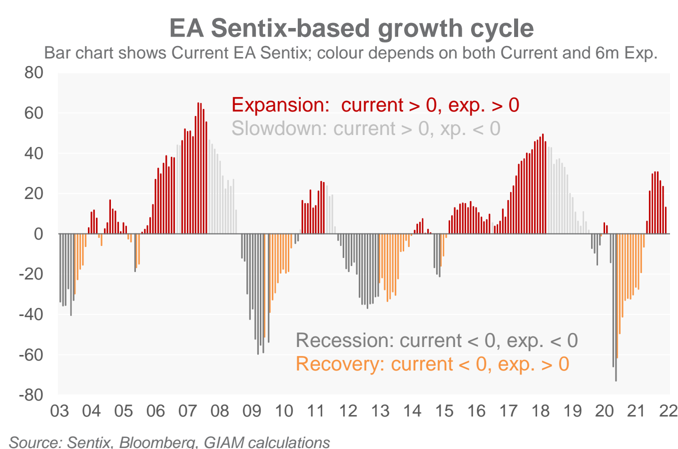
60-40 stock-bond portfolio... party over

Source: MSCI, Bloomberg, GIAM;calculations

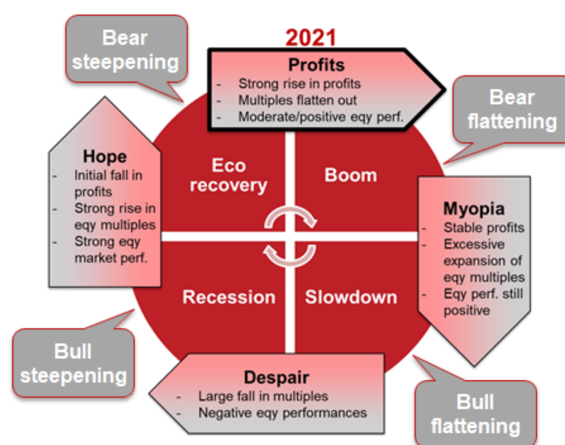
The recovery carries on in 2022; stagflation is overrated

The central scenario however has variants getting more infectious but less lethal

Pandemic (only) a tail risk. We end 2021 as another Covid wave seems to grow, the fifth one globally. Mutations tend to make viruses more contagious but less lethal; early indication on Omicron suggests the same. The vaccines so far have done a great job decoupling Covid hospitalisations and deaths from the number of cases. But vaccines have been less effective in taming contagion; even the WHO now recognises that they are not circuit breakers. This creates a tail risk of mutations producing a variant that would fully escape individual vaccine protection. This would cause havoc in our global social and economic lives. The central scenario however has vaccines continuing to effectively reduce the severity of the cases. New drugs and treatments will also contribute to reducing the threat in 2022, hence we assume that new waves will not derail the recovery.



Source: Sentix, Bloomberg, GIAM calculations



We expect the global economy to stay firmly in "expansion" in 2023, and financial markets to behave accordingly – as per the economic and in-vestment cycle clock

The recovery has legs. Various regions are at different stages of the recovery. China's GDP was first to retrieve pre-Covid GDP and quickly returned to trend. Policy tightening in late 2020 led to a significant slowing in 21H2 and we expect that a calibrated easing will help the economy find its feet in 2022. The US economy reached a new high in 21Q2 but has not yet returned to pre-covid trend. Europe is about to recover the real GDP level of 19Q4. Japan is lagging. Overall, we find that the recovery is still young. The left chart above measures the position in the cycle through the lens of the Sentix investor survey and combines the current conditions and 6-month expectations. Both components are currently positive, which we define as the "expansion" (or "boom") phase of the cycle. 2011 was an exception as the post-GFC recovery was far more muted and fragile, while policy mistakes contributed to the EA crisis that quickly followed; otherwise "expansions" tend to run for at least a couple of years; this one only technically started in Spring 2021, and despite the speed bump met over 22H2, is set to continue well into 2023. As we discuss in the macro section, we think this recovery has legs. The global consumer has built an impressive extra savings through the pandemic; though we do not expect this to be spent frenetically as services fully reopen, this should still help to absorb the negative shock on purchasing power coming from the inflation surge. Corporations are also very cash rich, and rising wage pressure will lead them into capex spending to support automation and productivity gains. Climate change policies will also feed into capex. Though there is still much uncertainty about President Biden's "Build Back Better" plan as we go to press, globally the fiscal retrenchment will be slower than it has been historically after recessions.

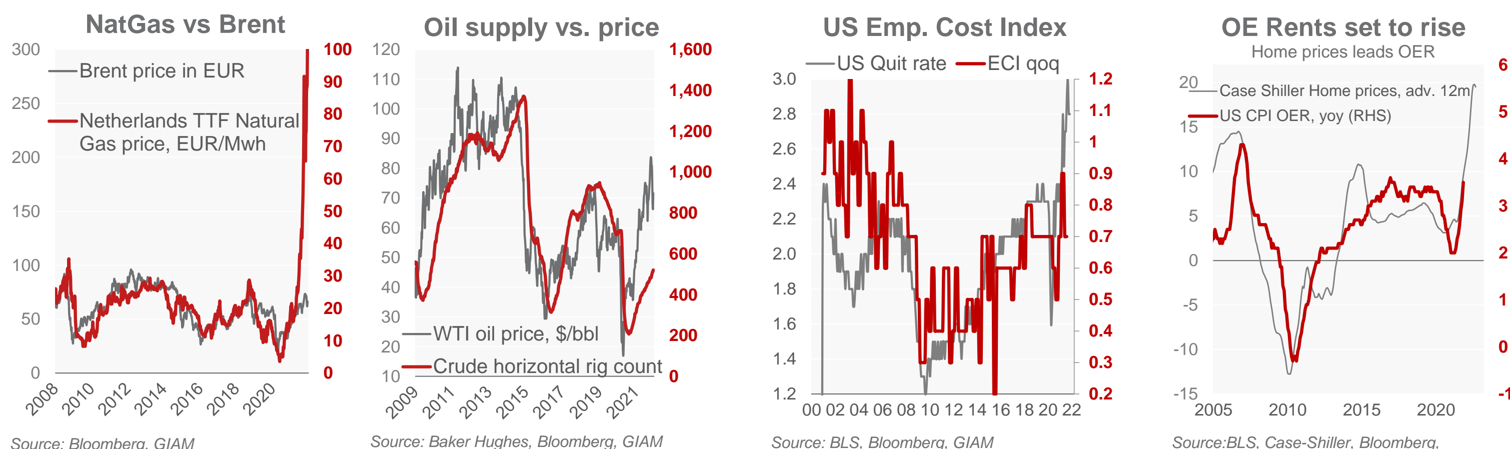
➔ So we expect the global economy to stay firmly in "expansion" (boom) in 2023, and financial markets to behave accordingly – as per the economic and investment cycle clock described above. Growth will be slower than in 2021 (5.8%) of

course but still above potential. This is particularly true for the Euro Area, where we foresee 4.5% growth in 2022 following 5+% in 2021. The key question is what this will mean for inflation, and the central banks' reaction functions.

Inflation is not just transitory

Climate change policies, wages and home prices imply upside inflation pressure, particularly in the US

Some permanent pressure in the pipe. Of course, we do not expect headline CPI inflation to stay as high as 6.8% in the US or 4.9% in the EA. The shock is partly transitory. But partly only. Early in the pandemic we discussed factors that may stop inflation from returning to the pre-Covid subdued path (size of the policy shock, de-globalisation, ageing, increased policy focus on inequality and the level-playing field, climate change policies). Climate change policies are already having an impact. The old fossil energy sector has been under-invested over the past years; renewable energy requires heavy investments that can only be done progressively. In the meantime, the energy transition may not be as smooth as desired. Already in 2021, climate events that disrupted renewable energy production, combined with geopolitical tensions (Russia), made the transition risks evident: as we go to press natural gas prices in Europe remain at dizzy high levels. Nuclear outages are adding insult to injury. Focus in 2022 will also be on oil prices; Omicron has caused a correction, but we see this as a temporary shock on demand; supply is no longer adjusting as much to price increases (see chart) and the risks are skewed towards a disorderly rise in prices.



Regional differences. Cyclical pressure may also continue, especially in countries like the US, the UK and Canada. The right-hand side charts focus on the US. The tight labour market is seeing a surge in the quit rates, which will feed wage pressure. Home prices have strongly accelerated, and OER (owner equivalent rents) will follow up in the coming months and quarters. The pressure is not as strong in the euro area, where wages have been more muted, but the next round of wage negotiations will be an important metric for second-round effects.

Monetary policy uncertainty has increased; look for more hawkish surprises

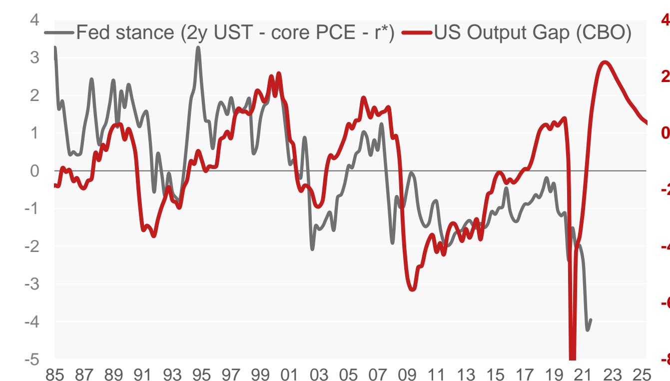
Higher policy uncertainty, with bias towards a more hawkish approach than priced

Policy uncertainty feeds into financial volatility. Monetary policy uncertainty has increased for at least three reasons. First, we see signs of a mild easing in the global supply chain disruptions, but repeated Omicron waves are only delaying the normalisation. As discussed above, risks of disorderly energy price rises have increased. Second, it is never easy for central banks to address supply shocks: they create a negative pressure on growth, but a positive one on inflation. The balancing act is not easy to calibrate and predict. Third, both the Fed and the ECB have adopted new mandates; that has made them generally more tolerant of temporary inflation overshooting, but no one has seen them operate in these new frameworks. That increased uncertainty will translate into more volatile financial markets. Already bond volatility

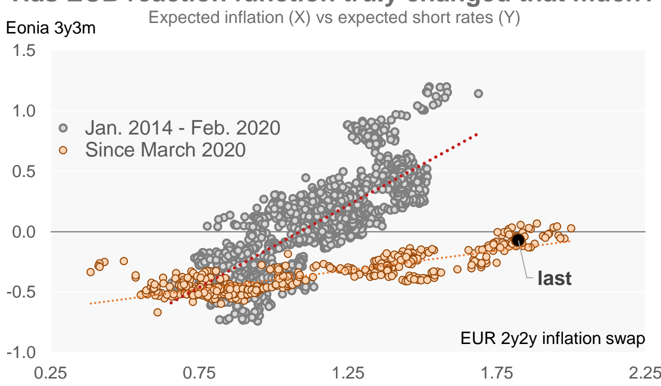
has picked up significantly.

We expect the ECB to predict far more cautiously, given the weaker underlying inflation trends. But even there, investors may revise their expectations – like they did for the Fed through 2021

Hawkish surprises set to continue. The left chart below compares a measure of the Fed's policy stance to the US output gap (CBO estimate). We need to be humble with such analysis as the natural real rate (r-star) and the output gap are not directly measurable and depend on assumptions. Yet our measure of the Fed's stance does not even include the surge of the balance sheet, so it is fair to say that it is extremely accommodative. And this happens as the output gap may be about to close, i.e. the economy is running close to full capacity. Elevated inflation is clearly upsetting households and SMEs (surveys), which the Fed cannot ignore. The December FOMC suggested three hikes were in the pipe, after QE ends in early Spring. We assume Quantitative Tightening (QT) will not start in 2022, but this is a point to follow very closely, given the potential impact on long-term yield and the yield curve. We expect the ECB to predict far more cautiously, given the weaker underlying inflation trends. But even there, there is room for investors to revise its expectations – like they did for the Fed through 2021. The right-hand chart below shows that despite a very significant increase in EUR 2y2y inflation swaps, the market still sees short-term rate below zero in 3 years. As risk premia grow along with the menacing tone from the ECB hawks, there is room for such implied rates to move higher.



Source:CBO, BEA, Lubik-Matthes, Bloomberg, GIAM



Source: Bloomberg, GIAM calculations

How to invest in 2022?

In line with the guidance from the investment cycle clock above, we expect equities to deliver positive returns again in 2022, but both more subdued and volatile. The most important financial variable to watch remains long-term real rates, which are an anchor to valuations across all asset classes.

Source: Bloomberg, GIAM

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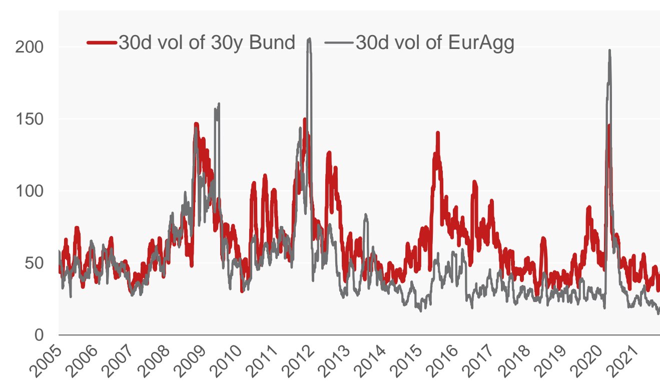


Source: Bloomberg, GIAM calculations

A moderate increase in long-term rates. The increase in bond market volatility,

We expect self-correcting mechanism (debt sustainability, financial and economic dependence on low long-term real yields) to keep the rise in bond yields limited in 2022, but the direction of travel is north.

as central banks navigate between tackling inflation and making sure financial conditions still support the recovery, is the mother of financial volatility. It is not just bond yields that matter, but their breakdown. In 2021 nominal yields increased much less than inflation expectations (and breakevens), as real yields continued to fall. The left-hand chart above shows the decoupling between medium-term policy expectations and long-term real yields. This can always be explained ex-post (belief in a low equilibrium rate, flow and stock effect of QE, LDI flows etc.) but is still surprising. Likewise, the EUR 5-30y slope looks too flat at this stage of the cycle, as long-term nominal yields have proved remarkable stable and resilient to the threat of policy normalisation (e.g. end of PEPP in March 2022). We expect self-correcting mechanism (debt sustainability, financial and economic dependence on low long-term real yields) to keep the rise in bond yields limited in 2022, but the direction of travel is north.

Stay long Credit

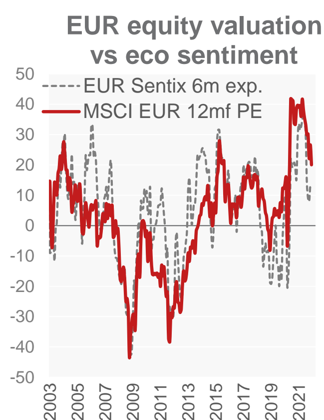
Our view on Credit is rather constructive. The widening of Nov. 2021 was a reminder of the more challenging times ahead, yet solid fundamentals (cash positions, rating migration, low default rates, residual ECB support) and the recovery should keep spreads tight and ensure excess return against risk-free bonds. Expect the ECB greening implementation to significantly impact sector and security performance.

Barbel Value and Defensive Growth in equities

There is still life in equities, as the earnings consensus is not too demanding; we see earnings growth around 10% on both side of the Atlantic, with a bias to the upside. The recovery should still support positive, if lower, returns (bottom-left chart). Valuation is not cheap, with US and EUR 12-month forward PRs around 21 and 15 respectively. But it is when compared to bonds, and real yields (second left-hand chart). The PE gap between Europe and the US is wide and reached new highs on Omicron; we have a small preference for European stocks. This also fits with our Value bias, which should benefit from the rise in bond yields (bottom-right chart). Yet the more volatile environment requires solid diversification into Quality and Defensive Growth.

The upcoming Fed hikes and further repricing of the policy path keep the USD supported for now, yet we the dollar is already starting to look rich on a fundamental basis. EM markets have generally underperformed relative to DM markets through the pandemic (FX, equity, and debt); we see more promising perspectives in 2022, but Fed hikes and near-term dollar strength will cap excess returns.

This report has much more to offer, including detailed macroeconomic and asset class sections, as well as a specific asset allocation section. We wish our readers a happy holiday season and successful investments in 2022.



Source: Sentix, MSCI,

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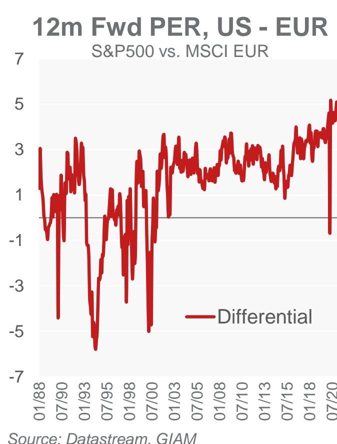
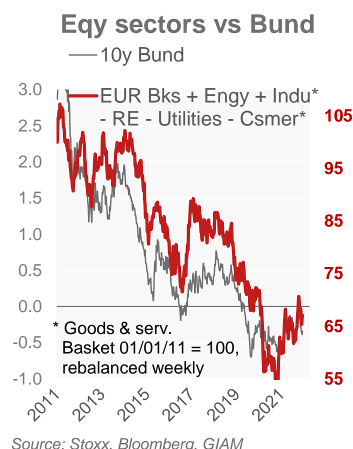


Source: Datastream, GIAM



Source: Stoxx, Bloomberg, GIAM

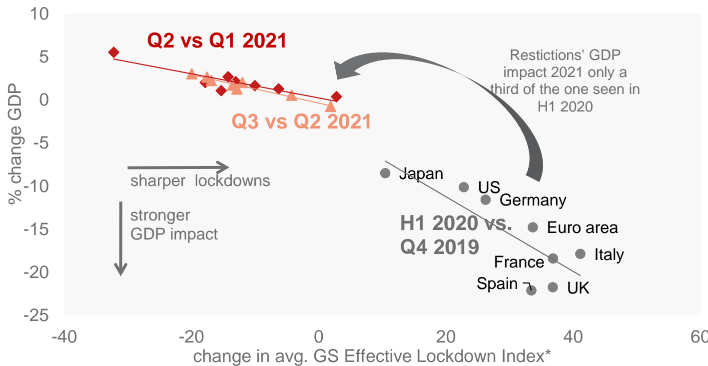
MACROECONOMIC OUTLOOK

Thomas Hempell, Christoph Siepmann, Martin Wolburg, Paolo Zanghieri

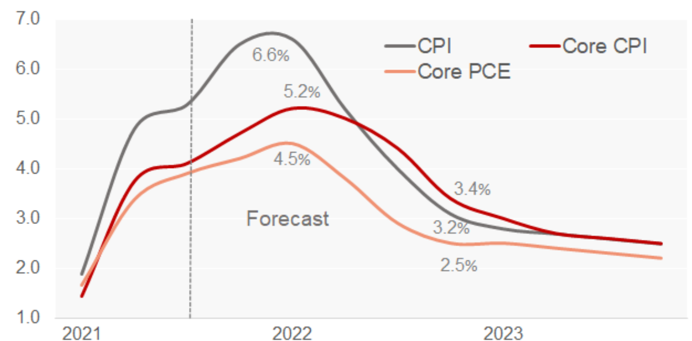
- **The global recovery still has legs into 2022. The Omicron variant is clouding the outlook in the near term. Yet progressing vaccinations and learning effects will help to contain the economic fallout.**
- **A persistent inflation overshoot and second-round effects are a key risk which may trigger a stronger policy response. Among major economies, risks of faster rate moves are highest in the US, but less acute in the euro area or Japan. Many EMs may need to tighten policy further to anchor expectations and exchange rates.**
- **A strong labour market supporting consumption and the capex cycle will allow steady growth in the US. Inflation will decline materially only in the summer. The Fed will stop net bond purchases in March, but reinvestment will continue. It plans to hike rates three times in 2022.**
- **With a relapse into lockdown being avoided, the euro area recovery is set to continue amid high but easing inflation rates. The ECB will scale down QE in 2022 in order to be prepared for a possible anticipation of a first rate hike from 2024 to 2023.**
- **After the PBoC cut its reserve requirement ratio in December, we see more leeway for China's policymakers to support growth and stabilise the real estate sector. However, we do expect a full reflation cycle.**

Consumption and increasingly also capex will underpin the recovery, even if at a slowing trend rate

The global recovery is set to extend in 2022, but at a slowing pace. With many economies having recovered pre-pandemic ground, governments and central banks will cautiously withdraw their support. Consumption, cushioned by high savings, will remain the backbone of the recovery and capex is set to pick up (esp. in the US), helped by favourable financial conditions. Supply bottlenecks will gradually ease, with a shift of consumption towards reopening services (tourism, hospitality) helping to prolong the recovery. Yet risks from inflation and the new Omicron variant complicate the outlook. Persistent inflation overshoots risk de-anchoring inflation expectations (especially so in the US), entailing the risk of a stronger response by monetary policy, while high price pressure would dent real disposable income.



Source: *Goldman Sachs, Datastream, GIAM calculations



Source:, BLS, CEA, Refinitiv, GIAM

Omicron risks cushioned by jabs and learnings effects

Governments and firms have learned to better cope with the pandemic

The Omicron variant is proving highly infectious and may trigger a resurgence in cases. First, very tentative, evidence points towards somewhat lower severeness of diseases, but several countries may still feel forced to temporarily tighten restrictions. Yet encouragingly, the economic impact may still prove less dramatic. Vaccines (especially boosters) and new drugs still mitigate hospitalizations and deaths. Governments have learnt to resort to more targeted restrictions. And the economic impact of the restrictions on activity is much smaller than in 2020 (see left chart above).

A growing headache at central banks is inflation as supply disruptions and high energy costs are set to keep inflation elevated globally into 2022. Easing Covid disruptions, demand shifting back towards services and fading base effects will help price pressures to moderate but the risks from Omicron for sure complicate the picture. Central banks face a balancing act. While their tools are ill-suited for countering supply-side price shocks, they still need to prevent sustained price pressures translating into 2nd round effects via rising wages and higher inflation expectations.

Central banks need to prevent supply-side price shocks from morphing into self-feeding price pressures

Mind important regional differences, though. The US and UK are among those economies facing the highest inflation risks as their labour markets are turning hot. Not surprisingly, the Fed (seconded by the BoE and smaller G10 banks) will lead the tightening cycle, as detailed further below. By contrast, inflation risks are lower for the euro area (and Japan, Switzerland), with no signs yet of rising wage pressures and muted inflation expectations. EMs, by contrast, have been forced to tighten much more aggressively with CB inflation credentials weaker and FX depreciation another risk to contain. But note the exceptions of China and EM Asia, where bottlenecks have been less virulent.

US: solid growth and inflation risks back gradual monetary tightening

US Growth nears 4%, with an important role for private investment

The US economy is set to grow at just below 4% in 2022. Solid labour income will contribute to the steady expansion of consumption and capex will become a key driver of domestic demand. With income support measures expired, fiscal policy will be a drag on growth, only partially mitigated by the boost from the package the Democrats are striving to get approved in the Senate. Risks to the growth outlook arise mainly near term from the impact of the Omicron variant due to the low vaccination rate (only 60% of the eligible population are fully jabbed). Headline CPI inflation will likely remain above 5% yoy until Q2 and the core rate will end the year above 3% yoy. Risks are tilted to the upside: tentative signs show supply bottlenecks easing, but services prices are staging a gradual increase. Shelter inflation is worrying, as house prices continue to increase at an unprecedented pace (19% yoy in September).

Inflation risks pivot the Fed towards three rate hikes in 2022. Balance sheet may start shrinking in H1 2023

Stubbornly high inflation and the strong labour market have pivoted the Fed to a more hawkish stance. The unemployment rate fell to 4.2% in November, much lower than the year-end level of 4.8% projected by the FOMC in September. In the December meeting the Fed announced that bond purchases will stop by mid-March. In order to strengthen its commitment to fight persistently high inflation, and counting on a solid economic performance, it also signalled three rate hikes for 2022, which is now also our baseline. Looking at the past hiking cycle this could be consistent with the shrinking of the Fed balance sheet occurring as early as in the first half of 2023.

ECB to cautiously embark on policy normalization

Omicron and bottlenecks to dampen but not to derail euro area recovery

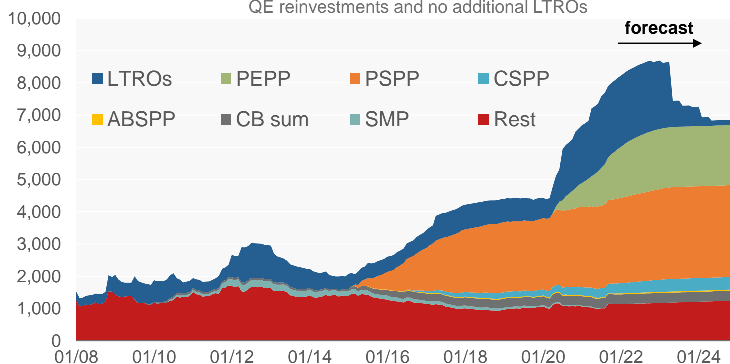
The euro area economy has strongly recovered in 2021 and will reach the pre-pandemic output level by year-end. Yet, following strong growth over the summer half, the emergence of Omicron amid renewed stringency measures, bottlenecks in key input markets and a lower catch-up potential point to a blip in the winter 2021/22. That said, more tailored pandemic measures avoiding a full lockdown should still allow for GDP growth by 4.4% in 2022. The recovery will be supported by easing inflation that supports real income growth.

Headline inflation has sky-rocketed to 4.9% yoy in November, driven by a trinity of base effects, higher energy prices and supply bottlenecks. In 2022, these factors are set of abate, sending inflation back below the 2% threshold in the second half of the year. That said, the low inflation regime of the past years will be over and annual inflation will average 2.3% in 2022. Core inflation is seen to gradually come closer to the ECB’s 2% target in the years to come while inflation expectations have already

normalized.

The monetary policy environment has changed markedly. A rate hike is not yet on the table as the new ECB strategy has markedly raised the bar for an early tightening. Headline and underlying inflation must be consistent with the 2% threshold well before the end of the ECB projection horizon (currently 2024). But unlike the past upside risks to inflation are widely acknowledged and the ECB will want to be prepared to act in all contingencies without causing market gyrations. It will most likely terminate the PEPP in March 2022 but smooth the reduction of monthly QE purchases over the rest of the year via enhanced APP purchases. It may then be ready to anticipate its first rate hike from 2024 (base case) to 2023, e.g. if second-round effects from the current inflation spike were to materialize.

Inflation to come down but low inflation environment to be over



Source: Datastream, ECB, GIAM calculations

Source: Datastream, GIAM calculations

The ECB's balance sheet will likely peak in late 2022 and shrink afterwards. There will be measures to avoid a sharp fall, e.g. related to expiring LTROs. However, the way is clear: 2022 will be the year in which the ECB starts unwinding its ultra-accommodative policy stance.

ECB to scale down QE purchases in 2022 but not to hike rates yet

China's policymakers to focus more on stabilising growth

China's growth has suffered from a range of headwinds recently, including multiple local Covid-19 lockdowns, power outages, the marked slowing of the real estate sector as well as regulatory tightening measures. After deleveraging the economy was very much in the focus for most of 2021, policy makers are now giving the stabilization of growth a higher priority. The PBoC cut its reserve requirement ratio (RRR) by 50 bps. Moreover, the growth rate of the broadest credit aggregate – Total Social Financing – edged up. This cautious easing stance is set to continue but we see no full reflation cycle. We expect another RRR cut by 50 bps in H1 2022. The newly introduced monetary lending facility to support decarbonization could also help to support liquidity. Fiscal expansion will likely be more frontloaded. We would expect more decisive policy easing with an interest rate cut only if Omicron triggers more frequent local lockdowns.

PBoC to cut reserve requirement ratio again by 50 bps

The slowing real estate sector, combined with (near) defaults of property developers, could prove a major drag on growth in 2022, if unmitigated. We expect the government and the PBoC to pursue a stabilisation. Policymakers have started to work on ensuring funding for healthy developers, and relaxing mortgage lending and housing purchase restrictions at local levels. This policy will likely be enhanced, e.g. by affordable housing programmes. However, we do not expect a broad-based re-leveraging or major bailouts of property developers. All in, we see growth at 4.8% in 2022, and inflation to rise to 2.3%.

GOVERNMENT BONDS

Florian Späte

- **After a long period of very accommodative policy, central banks are seen to tighten policy in 2022. Notwithstanding a high degree of uncertainty about the details, it will increase volatility of bond markets.**
- **As financial markets have not yet sufficiently priced the reaction of central banks to a changing inflation regime we forecast long-dated yields to rise well above currently priced forwards.**
- **However, government bond yields will remain at a historically low level. Particularly low real yields are necessary to tame concerns about debt sustainability and to prevent a sharp downward correction of asset prices.**
- **Euro area non-core government bond spreads appear vulnerable at current levels. The scaling back of ECB bond purchases in combination with an only modestly decreasing net bond supply is paving the way to a moderate spread widening.**

After terminating bond purchases in spring 2022 we expect the Fed to kick off a new rating cycle and hike three times in 2022. While this is almost priced, we differ regarding the long-term outlook. Amid concerns about a slowing of the economy in 2023 and a corresponding strong decrease in inflation financial markets currently expect the peak of the Fed policy rate at 1.5%. As outlined in the macro section, we are more constructive on the growth outlook and expect US inflation to decline only slowly. Hence, we forecast a peak key rate above 2%. While we do not share the Fed's own longer-term expectation of 2.5% the central bank will hardly ignore consumers' concerns about high inflation. Accordingly, we expect that financial markets will adjust expectations over the course of 2022.

Long-dated US government bond yields to rise well above forwards as inflation turns out more sticky

This will give leeway for long-dated US yields to increase. While forwards only imply a level of 1.65% until the end of the year, we see scope for 10-year US government bond yields to rise to 2.0%. The bulk of the yield adjustment is likely to be borne by the real component. If history is any guide the end of quantitative easing and the start of a new key rate cycle will impact mainly real yields. Nevertheless, they will remain at a comparatively low level and even 10-year real yields will continue to be well in negative territory. It should not go unmentioned that the forecast is subject to a greater degree of uncertainty than usual. In particular, the development of Covid-19 is an important factor. Accordingly, we do not expect a sustained yield increase until concerns about new variants and further waves have been overcome - which we assume in our basic scenario.

As we do not deviate substantially from market pricing regarding the Fed stance for 2022 and 2023, we expect the short end of the curve to move upwards largely in line with priced expectations. Until the end of 2022, we forecast 2-year US yields to reach 1.35%. Hence, the flattening of the US curve is seen to continue over the course of 2022.

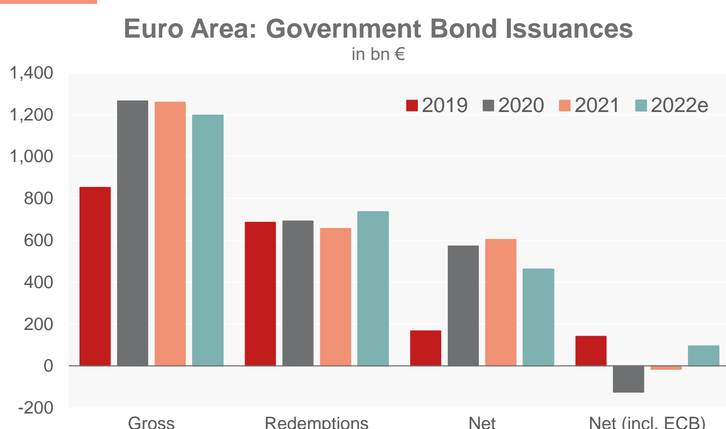
ECB a laggard in international comparison, but current pricing for negative deposit rate even in 2026 overdone

The situation in the euro area is less straightforward as the ECB can afford to adopt a less hawkish stance. Inflation pressure is less pronounced, and we forecast annual inflation to move back towards the target over the course of 2022. Notwithstanding that, the central bank will also show its teeth and will increasingly reduce the degree of policy accommodation. However, the currently priced 10 bps hike of the deposit rate until the end of 2022 appears too ambitious. However, the long-term expectations appear too low. Financial market expect that the ECB deposit rate will remain in negative territory even in five years. As in the US, we forecast an adjustment of market expectations over the course of 2022.

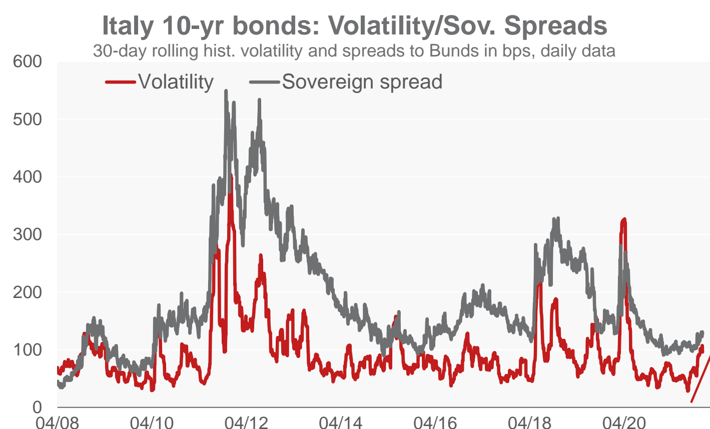
Decrease in euro area net supply overcompensated by scaling back of ECB purchases, but net-net supply to remain below 2019 level

Moreover, we forecast the ECB to scale back its bond purchase programme. Depending on the evolution of the macroeconomic situation we forecast the ECB to almost halve the volume it will spend on euro area sovereign bond markets. This is not only because it will reduce the total volume, but also because it will buy more EU bonds. With a volume of around € 200bn, the EU will be the largest net supplier of EUR-denominated government bonds in 2022. The forecast decrease in net supply across euro area countries by more than € 140bn will not be sufficient to make up for the reduced ECB purchases. Hence, net-net supply will be positive again. We expect a volume of just under € 100bn (a swing of almost € 100bn compared to 2021).

The combination of increasing US yields, an expected adjustment of long-term key rate expectations, less ECB support, and an economy still growing above potential will contribute to a rise in long-term yields. While forwards only imply a slight increase of 10-year Bund yields to -0.25%, we forecast a level of 0.10% by the end of 2022.



Source: Bloomberg, Datastream, GIAM calculations



Source: Datastream, GIAM calculations

Again, the increase will largely be driven by higher real yields amid a by and large fairly priced inflation outlook. Even considering the increase, real yields will remain clearly in negative territory and just exceed the -2.0% threshold. A stronger upward movement appears unlikely as asset valuation and debt sustainability depend on low real yields. Hence, there is a self-correcting mechanism that prevents a too strong yield increase.

As a first ECB key rate hike is not on the cards for the time being, we see only a very moderate upward trend of short-dated yields. Accordingly, the steepness of the yield curve will to a large extent be determined by the development of the long end.

Declining ECB support to leave its mark on euro area non-core bonds

Political uncertainties and more volatile bond market environment to trigger higher euro area non-core spreads

Despite a moderate upward trend since autumn euro area non-core government bond spreads are still rather low by historical standards and they look vulnerable to a shift in the narrative from the ECB. The tighter central bank liquidity will dampen the current carry-friendly low volatility environment. Moreover, the forecast increase in core yields will reduce the search for yield. Additionally, the political environment will become bumpier in 2022. Presidential elections both in Italy and France have the potential to have a lasting impact on the currently calm political environment and cause some market turmoil. Finally, as outlined above the technical situation will deteriorate. The increase in the net-net supply in the euro area is almost entirely due to higher net supply from Italy, Spain (and France).

Notwithstanding that, solid growth, still accommodative monetary policy, and the support from NextGenerationEU will prevent a disorderly increase in risk premiums. Overall, we forecast a moderate spread widening, which will probably eat up the carry.

Elisa Belgacem

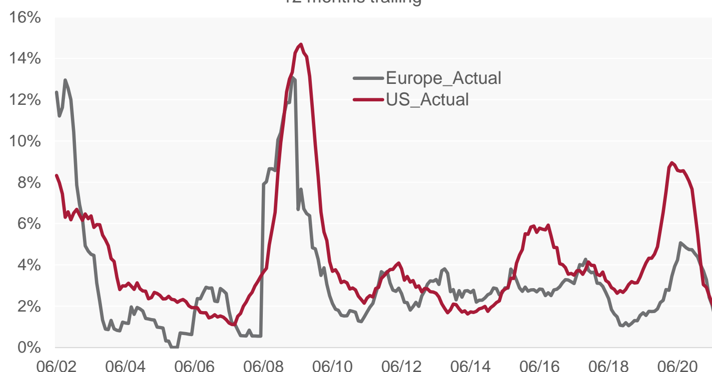
- **Credit spreads should remain well supported in 2022, mostly thanks to their attractive carry to volatility profile.**
- **Fundamentals, both defaults rate and ratings will continue to improve next year, albeit more slowly than in 2021.**
- **Inflation is in theory supportive for credit helping companies to deleverage, but this effect may be dampened by higher interest rate volatility. Retailers are most exposed, given their weak pricing power.**
- **We expect the ECB to maintain its support to the IG credit market in 2022.**
- **ESG will become a key factor as the ECB will be greening its purchases. ESG concerns also reduce the attractiveness of oil companies as a credit hedge to high commodity prices.**

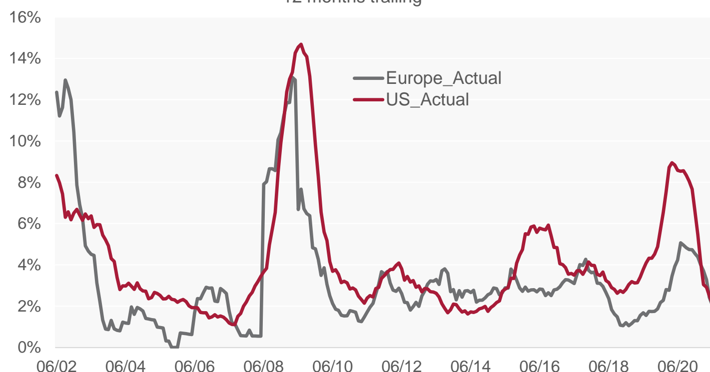
Volatility has remained very low in credit markets for most of 2021, and from that angle 2022 should look different. Yet we are convinced that credit is likely to remain resilient relative to the rest of the fixed-income space thanks to both strong fundamentals and technicals.

Fundamentals will continue to improve in 2022 albeit at a slower pace.

Fundamentals to remain strong but second derivative turning negative

First, the credit fundamentals will continue to improve. On one hand we have seen the default rate normalising extremely fast, and currently it stands slightly below 2% in Europe according to Moody's, below the long-term average. We expect the default rates to remain near those levels over the coming quarters. Similarly, on the rating side, the current trend is extremely favourable. We continue to expect more upgrades than downgrades in 2022 but the pace of normalisation will be slower than in 2021 as the catch-up effect from the massive wave of Covid-implied downgrades is fading.





Stable ECB purchases and moderate supply support technicals

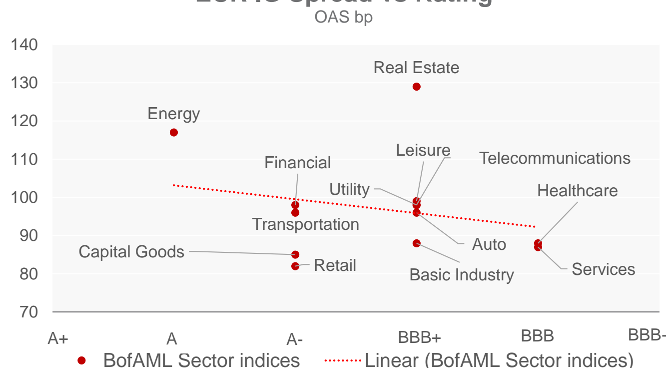
Technicals should also continue to help in 2022 as we expect the ECB to remain more supportive to the credit markets than consensus would suggest. On average the ECB has purchased between EUR5bn and EUR7bn of credit in 2021, and we believe that the overall reduction of purchases will not be made to the detriment of private bonds. Indeed, As long as QE is in place we think that the ECB have an interest in remaining active in credit as the cost of fighting fragmentation there is much lower than on sovereign bonds. Moreover, the ECB is expected to implement its climate policy over the second semester of 2022, and the larger their presence on the market, the greater the impact they will have on markets. Climate is indeed a key pillar of their strategy review announced in July 21. Assuming the ECB its credit purchases remain

at the current level, net supply should be largely unchanged compared to 2021, marginally down for IG versus marginally up for HY. This should act as a supporting factor for markets.

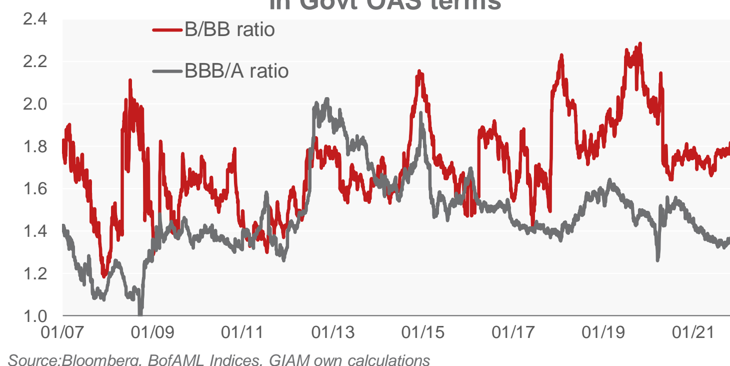
ESG playing becoming even more important in 2022

ESG impact on valuations will grow over the course of next 2022 und the ECB pressure

The ECB will not only support spreads overall, but the implementation of its credit strategy is likely to further increase the valuation dispersion between ESG winners and losers. Indeed, the central bank is aiming at both making minimal requirements for purchase eligibility and tilting the purchases towards the most virtuous players. At this point no details were given regarding what type of criteria could be applied to tilt the purchases but it appears likely that the ECB will closely look at what the Bank of England has announced at the end of 2021. BoE is aiming at a 25% decrease in emissions from corporates included in the portfolio by 2025 and net-zero by 2050. On the tilting of criteria they use a multi-faceted approach including: (1) the level in emission intensity, (2) the past reductions in absolute emissions (relative to sector-specific pathways for high emitters), (3) the publication of climate disclosure, and (4) the publication and third-party verification of an emissions reduction target.



Source:Bloomberg, BofAML indices, GIAM own calculations



Source:Bloomberg, BofAML Indices, GIAM own calculations

Inflation is positive for credit on the paper

Theoretically, inflation is good for credit as it helps companies to deleverage. However, the peculiarity of this recovery makes things different. Indeed inflation has picked up but real rates have remained subdued. Any material rise in real rates might be challenging for risky assets. Indeed not only negative total returns will trigger outflows from credit funds but also credit is highly reliant upon the ECB support that is likely to be challenged by high inflation prints.

Inflations is theoretically supportive for credit but higher real rates may prove challenging for risky assets in general

In terms of sectors, we believe that the most vulnerable ones to higher inflation would be non-food retailers, building materials, and OE suppliers because of their limited ability to pass on higher costs to end customers. On the other hand, metal, mining, and oil companies have been historically performing well in times of rising commodity prices. Nonetheless, we believe that they might not be as much of a good hedge of what they used to be because of their poor ESG profile.

Moderately constructive outlook for spreads near term

Hence, we do not see valuations as particularly attractive but our OW credit rests on the favourable carry to volatility ratio versus the rest of the fixed income space. Within credit we prefer defensive carry to duration and recommend favouring BBBs, BBs, corporate hybrids and AT1s. A key risk to this scenario would be further inflation pressures forcing the ECB to hike rates and stop asset purchases sooner than our scenario, i.e., before end-2023.

EM SOVEREIGN BONDS

Guillaume Tresca

- **Expectations for 2022 are low as the macro backdrop for EM remains challenging in the wake of a growth slowdown, tighter monetary and financial conditions, and a still strong USD.**
- **We expect EM spreads to reach 300bp by year-end, targeting a low 5% total return. EM external debt is still a carry play, rather than a directional play. Higher interest rate volatility will hurt appetite and offset some of the carry.**
- **Most of the value will come from idiosyncratic stories. We still slightly favour EM IG over HY and focus on BBBs and oil exporters. In the HY space, we do not expect a repetition of 2013, but default risk is still to monitor.**
- **Declining gross issuance will provide some support. ESG issuance will continue to rise rapidly with new countries coming to the market. Investors' framework on EM ESG will likely stabilise, setting the tone for new ESG issuances.**

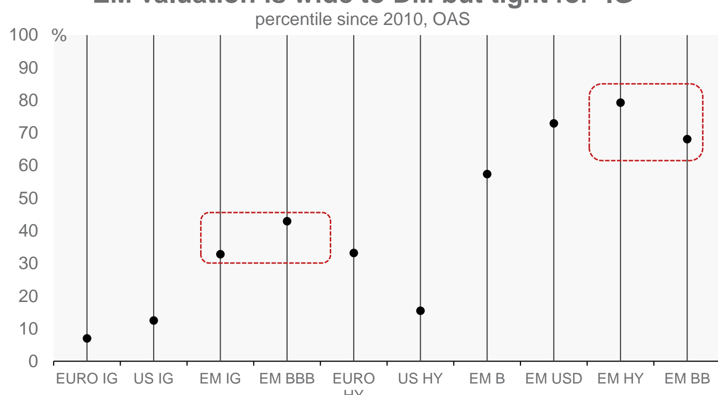
EM macro outlook has been challenging. Spread compression will be limited

Managing low expectations. 2021 should have been a recovery year, but it did not eventually meet the high expectations of EM investors with poor returns for all EM assets. Expectations for 2022 are low with several risks, and we target a low 5% return for EM external debt. Indeed, the macro backdrop for EM is challenging as growth will slow down from above potential level with a risk for EM growth to be lower than DM growth. Monetary policy tightening is underway in DM and EM countries as EM inflation is not decreasing. Even if the fiscal deficit will decline on average, the IMF expects debt-to-GDP to edge higher.

On top of that, the resilience of the USD coupled with higher DM rates and poor returns this year will cap portfolio inflows. Indeed, higher interest rate volatility will be one of the main pitfalls next year, and it will dampen the appetite for EM assets globally.

EM valuation is wide to DM but tight for IG

percentile since 2010, OAS



Source: Bloomberg, JP Morgan, GIAM calculations

Higher UST to lead to low TR in 2022

1Y TR for different scenarios, BofA index

OAS spread \ US 9Y	0.84%	1.04%	1.24%	1.44% (current)	1.64%	1.84%	2.04%	2.24%
264	9.4%	9.2%	9.0%	8.8%	8.7%	8.5%	8.3%	8.2%
274	8.5%	8.3%	8.2%	8.0%	7.8%	7.6%	7.5%	7.3%
284	7.6%	7.5%	7.3%	7.1%	6.9%	6.8%	6.6%	6.4%
294	6.8%	6.6%	6.4%	6.3%	6.1%	5.9%	5.7%	5.6%
304	5.9%	5.7%	5.6%	5.4%	5.2%	5.0%	4.9%	4.7%
314	5.0%	4.9%	4.7%	4.5%	4.3%	4.2%	4.0%	3.8%
324	4.2%	4.0%	3.8%	3.7%	3.5%	3.3%	3.1%	3.0%
334	3.3%	3.1%	3.0%	2.8%	2.6%	2.4%	2.3%	2.1%
344	2.4%	2.3%	2.1%	1.9%	1.7%	1.6%	1.4%	1.2%
354	1.6%	1.4%	1.2%	1.1%	0.9%	0.7%	0.5%	0.4%
364	0.7%	0.5%	0.4%	0.2%	0.0%	-0.2%	-0.3%	-0.5%

Source: Bloomberg, GIAM calculations

Interest rate volatility to limit the total return

Everything is not doom and gloom. Valuations have been mildly attractive compared to their DM equivalents by historical standards, and they have even recently improved in the wake of the Omicron sell-off. It can lead to some tactical compression, especially on the HY side. That said, we only expect EM spreads for the Bank of America index to finish the 2022 year at 300bp with a more supportive second part of the year. In other words, it will leave EM spreads back to their mid-November levels, which is slightly below the 10Y average. Still, on the positive side, the low level of real yields will continue to exert a significant force to limit spreads rebound.

It will lead to low returns by EM standards. As was the case in 2021, EM external debt in 2022 will be even more a carry play than a directional play. Higher UST yields will be the elephant in the room, offsetting a large part of the EM carry. Thus, relative-

value play will be more important, especially as the stronger USD and higher UST rates pressure the weakest EM countries.

Differentiate amid rising volatility!

Most of the value will come from idiosyncratic stories. The paradox is the EM index looks attractive compared to DM credit, but there is not much value at the country level. Due to the rising weight of distressed/defaulted credits at the index level and to the wide dispersion, especially in the HY space. Most of the 2022 return will be found on taking a view on weak names in an environment where countries with large external refinancing needs will be under rising pressure, leading again to wider dispersion.

We maintain a slight OW on EM IG over HY. But most of the alpha will be generated in HY

At the spread level, we maintain our slight OW on EM IG over HY despite tight IG valuations and the rising of higher UST rates. In our view, it is too difficult to be OW HY given the EM growth slowdown and USD strengthening. Thus, in the IG space, we essentially focus on BBBs. GCC countries like Qatar will continue to outperform in our view. Elsewhere there is value in countries with high political risk like Romania, Chile, or Peru. We avoid EM Asia IG countries.

In the HY space, dispersion is larger, leaving more room for alpha generation. We do not expect a repetition of the 2013 *Taper Tantrum*. External refinancing needs are stable, FX reserves are larger, EM central banks front-loaded the Fed, and the share of foreigners in the local market is lower. However, debt sustainability concerns remain, and so we focus on quality BBs. Again, HY oil exporters have room to outperform, and we like Colombia for instance. However, we see risks in countries with deteriorating fiscal metrics like Brazil, South Africa, or Turkey.

A little help from technical but mind ESG issuance

Lower gross issuance will provide a welcome support.

EM sovereign gross issuance should decline in 2022 by roughly 20%, close to USD150bn thanks to the pandemic recovery and the focus on fiscal deficit reduction. In the IG space, oil prices will provide a buffer, while in the HY space, the SDR allocation recently distributed provides an alternative source of financing for countries with limited market access. Considering the rise of cash flows, the net financing will likely be at the lowest level since 2015, providing some support to EM spreads.

EM ESG issuance is due to rise further. Question marks remains on how investors will apply the ESG framework to EM sovereigns

The expected rise of ESG issuance is more interesting, especially in MENA, likely led by a first green bond in KSA. There have been talks for a first green UAE bond too. The reception of these new GCC green bonds will be a good test for the investors' appetite as it is still difficult to apply the ESG framework to EM sovereigns. Appetite from EM retail funds has been growing, and the compliance on the new ESG issuances. However, there are still question marks on what ESG scores to focus on and whether it is needed to exclude countries or focus on the direction of travel.

For sure, ESG issuance will be larger than the USD29bn issued this year, and we would expect a new issuer to come. It is unclear yet to note a real premium for ESG bonds, given the limited sample size and their recent issuance.

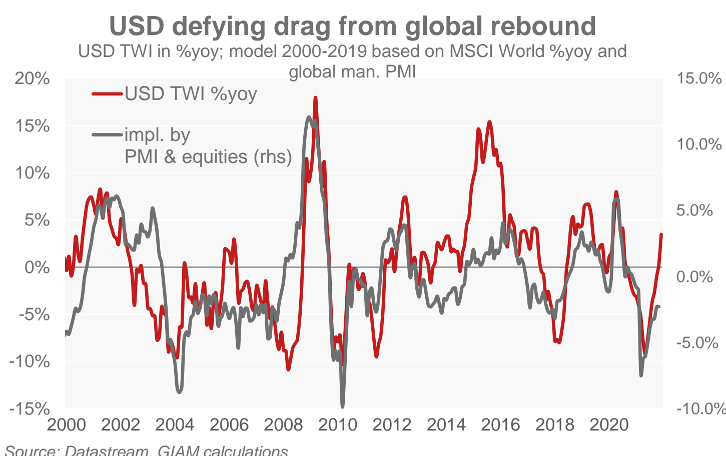
Thomas Hempell

- **The USD still has legs into early 2022 with FX markets dominated by monetary policy divergence. The Fed will accelerate its policy normalization, which strongly contrasts the much more patient ECB and perma-dovish BoJ.**
- **Yet, USD valuation looks stretched and structural headwinds will likely gain the upper hand over 2022. The global recovery is set to extend, burdening the anticyclical USD. Also, the unfavourable US external balance and global reserves diversification provide continuous USD headwinds and this year's strong technical support from the positioning shift is set to fade.**
- **USD strength may also become visible against the yen, but likely reverse later in the year.**
- **Global inflation worries and a continued reluctance on FX intervention may bring about more CHF strength near term, before rising global yields will take the EUR/CHF higher. The GBP remains underpinned by a hawkish BoE but this is largely offset by erratic communication and already advanced rates hike pricing in the UK.**

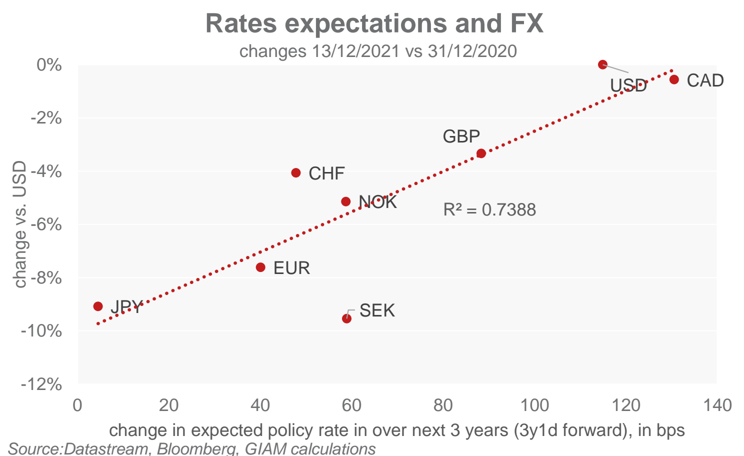
The H1 2021 global rebound weighed on the countercyclical USD. But mounting inflation worries and divergent repricing of monetary policy responses have proven the most powerful force on global FX markets in 2021 (see charts below). USD and CAD, who had seen the biggest increases in rate expectations over the year, have outperformed, while EUR and JPY were the laggards.

Monetary policy divergence may well continue to dominate into early 2022 amid ongoing inflation and policy uncertainties

With inflation and policy uncertainty still the key market themes into 2022, the USD still has some upside in Q1. Inflation risks are most acute in the US and the Fed is under pressure to not fall behind the curve. This very much contrasts the BoJ's persistently highly accommodative stance. The ECB is set to taper its extraordinary policy support via the PEPP program. Yet, the resulting support to the EUR will be limited as lower ECB purchases may translate into higher risk premia on Southern European bonds weighing on the EUR, which are not favourable for the EUR. An ECB rate hike (already priced by markets for next year) would be the strongest form of monetary suppport to the EUR, but this is still very unlikely in 2022. As a result, we expect the EUR/USD to move closer to 1.10 in early 2022 and the USD/JPY to rise closer to 115, also helped by a rise in US yields to which the JPY remains closely tied.



Source: Datastream, GIAM calculations

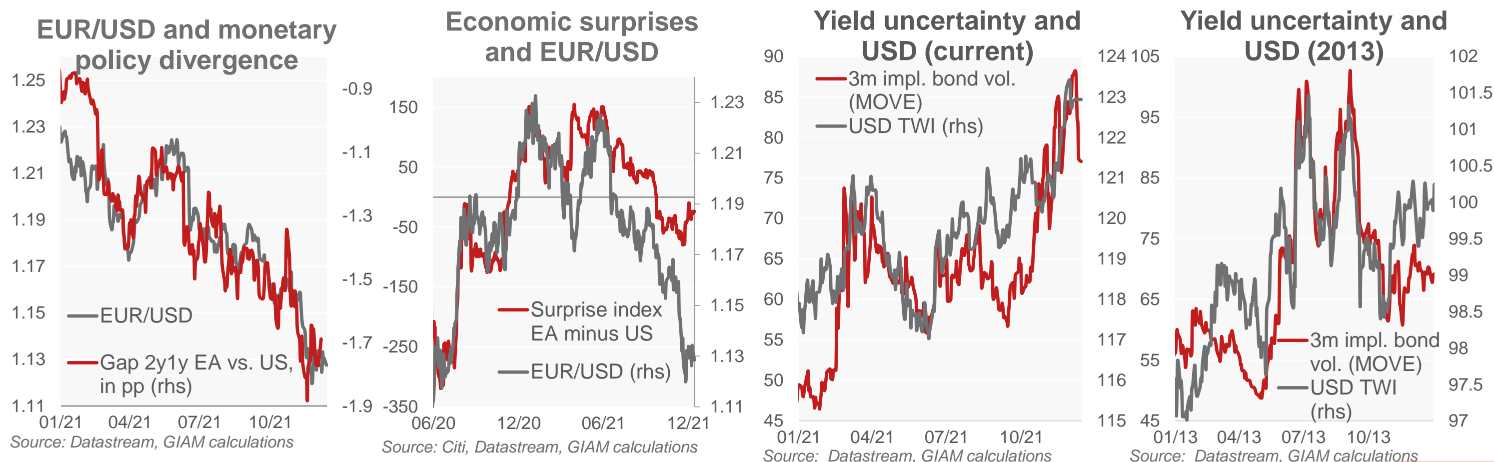


Source:Datastream, Bloomberg, GIAM calculations

The USD looks dear on various metrics, while the support from shifting speculative positions may fade

On various alternative metrics the strength of the greenback already looks stretched, though. Our internal market-based fair value model shows the USD dear by about 10% against the EUR, while the real effective (i.e. inflation adjusted) USD is also trading 10% dear vs. historical average. The USD's ascent in 2021 was also supported by a big shift in speculative net positions from a massive US$ 35 bn short in January to a more than US$ 24 bn long in early December, which is 1.3 sigma above historical

average. This big technical tailwind is likely to fade, if not to reverse over the course of 2022. The EUR/USD has matched divergent rate expectations but has undershot the relative economic data over autumn (see left charts below).



Headwinds to the USD will become more discernible over the course of 2022

Also, monetary policy will not dominate FX unlimitedly. Correlations between rates and FX tend to be highest amid policy uncertainty. At the same time, currently high rates uncertainty itself is supporting the USD, as it did during the taper tantrum in 2013 (see upper right charts). Volatility will mean-revert at some point in 2022 when more clarity evolves on the outlook for inflation and policy responses. Also, the ongoing global recovery – even if slowing – still points to some weakness in the anticyclical USD. Finally, the USD is facing persistent structural headwinds from ongoing reserves diversification and the still sizeable US current account deficit.

USD strength to reach its limits in early 2022

The overall outlook is therefore for some extended USD strength into 2022, with EUR/USD moving closer to 1.10 and USD/JPY eyeing 115 in Q1, before the USD may go into reverse. Conversely, the EUR will find support from mounting expectations of ECB rate hikes after 2022 and capital inflows (both from the euro area's C/A surplus and the ebbing of high net equity outflows seen in 2021). The JPY is fundamentally very cheap, and even if rising nominal US yields may drag USD/JPY somewhat higher near term, the much more favourable *real* yields in Japan still point to some JPY recovery over 2022.

Global inflation uncertainties keep underpinning CHF amid reluctance by the SNB to intervene

We expect some further strength of the CHF near term, as demand for the safe haven on high global inflation worries remains elevated. The SNB is showing little willingness to curb the franc's strength by meaningful FX intervention. This may be a tacit consent to some mild monetary tightening via the exchange rate. Yet, we ultimately see EUR/CHF ending 2022 higher as Bund yields rise and a safe haven flows from previous years unfold.

We expect the EUR/GBP to trade largely range-bound. The BoE will remain among the front-runner of monetary policy normalization after its December rate hike, which underpins the GBP. Yet, the 1% key rate priced by markets for year-end 2022 looks excessive to us. Moreover, somewhat erratic communication by the BoE and persistent uncertainties over the Brexit deal and the Northern Ireland protocol in particular will sustain a political risk premium on GBP.

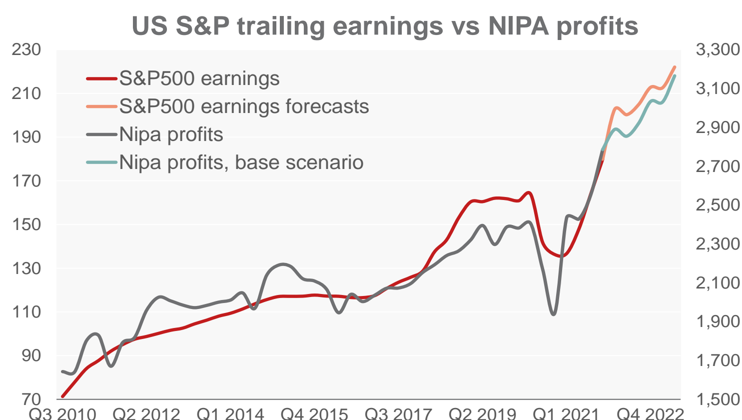
EM currencies will feel headwinds from tighter US monetary policy and slower Chinese growth, largely offsetting ensuing tailwinds from still favourable global growth dynamics on progressing vaccinations and reopening economies (incl. tourism). CEE-3 currencies look attractive as they may benefit from the European recovery, more attractive yield levels and – later in 2022 – a recovering EUR/USD.

EQUITIES

Michele Morganti and Vladimir Oleinikov

- **We forecast a positive total return (TR) of nearly 7% in the next 12 months, despite factoring in some further PE com-pression and the negative impact coming from a lower policy support. Indeed, fundamentals remain robust as GDP growth will stay above potential (near 4%) and yields contained, especially in real terms. Tactical indicators are neutral and quite far from an overbought position. We assume cautious earnings growth of 10%, which takes into account higher wage growth and lower momentum in capacity utilization.**
- **The problem is the increased volatility of future returns. It results from the tightening of the monetary stimulus, a less predictable response of monetary policy to high-for-longer inflation, a consequent more volatile risk premium, plus peaking confidence indicators and, finally, a visibly increased bond volatility.**
- **For these reasons, we maintain a cautious OW on equities, recommending a slight OW in EMU vs. US and a sector barbell strategy: OW Value (financials, energy to benefit from good GDP and higher rates) and defensive growth (staples, pharma, and durables). UW: utilities, RE and telecoms. We see neutral stance on EMs warranted.**

Positive returns, yes, but be aware of higher volatility. Equities still have legs in our base scenario as fundamentals remain rather solid. GDP growing above potential and lingering low yields are surely two good starting points. These underpin a fair value target in one year above current one (S&500 worth 4,700-5,200 range) and, which, adding dividends and assuming a further modest compression in PE, provides a total return of 7%. Tactical indicators are also rather neutral and both corporate cash and increasing buybacks insure against abrupt and prolonged drawdowns. That said, the difficult aspect of the next year's assessment is represented by an increased un-certainty and consequently possible higher volatility. Let's see why.



Source: Datastream, GIAM calculations

Shiller-based approach to valuation

US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p - 10y real)
Scenario 1 (current input with consensus CPI & 12m fwd earnings)	1.44	6.24	-4.81	218.0	4.52
Scenario 2 (consensus 12m forward in 1 year)	2.00	3.70	-1.70	239.0	4.96
Scenario 3 (GI 12m fwd in 1 year)	2.00	3.20	-1.20	228.4	4.74
Scenario 4 (downside macro scenario)	1.00	1.60	-0.60	158.5	3.29
Scenario 5 (upside macro scenario)	2.50	3.50	-1.00	251.0	5.21

using 20% of risk (SD)	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	22.5	24.7	23.6	16.4	25.8
Avg S&P500 valuation	4,468	4,897	**4,684**	3,249	5,119
	-2.4%	7.0%	2.3%	-29.0%	11.8%

Note: Base risk scenario: using 20% of risk premium's stand. deviation (SD=2.9%) adds around 60 bps to the average risk premium calculated since 1872 (4.1% + 60 bps = 4.7%). Target ERP (4.1) is calculated assuming CPI in the range b/w 2.0% and 3.2%.

Scenario 3 (GIE) with lower ERP (yield at 1.5%)	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	22.5	24.7	26.5	16.4	25.8
Avg S&P500 valuation	4,468	4,897	**5,261**	3,249	5,119
	-2.4%	7.0%	14.9%	-29.0%	11.8%

Note: We take lower ERP by 50 bps in scenario 3

Source: Datastream, GIAM calculations

Good fundamentals to be reflected in positive total returns

Good earnings growth in part offset by lower policy support and Covid waves

Earnings growth and low real yields. GDP growth will stay at about 4% in 2022, and, coherently to our proprietary models, we expect earnings to grow at around 10%. As a rule of thumb, please note that the earnings multiplier for a given real GDP growth has historically been around 3X. Our estimate incorporates the assumption of slightly decreasing margins in the next quarters. They are expected to remain solid on ac-count of both high CPI/ULC ratio and upbeat companies' statement. Indeed, firms see reasonable pricing power due to strong demand and are using workarounds and tech investments to enhance productivity to offset cost increases.

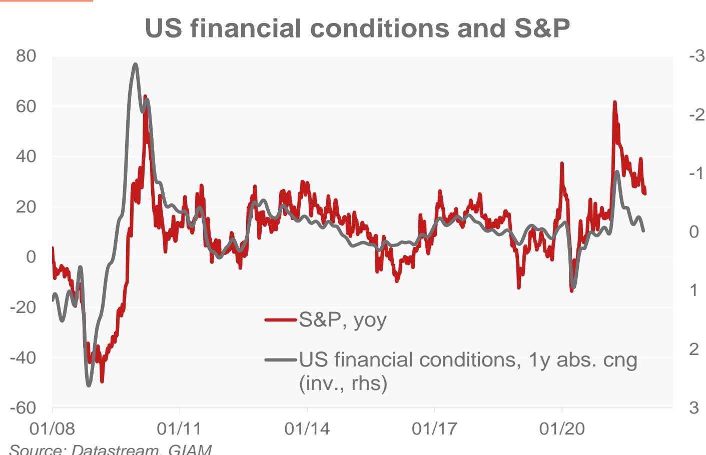
Having said this, we see increasing pressure from less strong momentum in capac-ity utilization, high-for-longer input costs, wage lifts and lower deficit spending vs 2021. For this reason, we prefer not to exploit all the potential (+12%-15%) from high

nominal GDP growth. Indeed, US Q/Q growth ex-energy has already been -1% in Q3 and Q4 revisions have been slightly negative since the Q3 season started. We dive into cross-asset returns through the cycle, looking at the yield curve, nominal and real rate "levels": equity returns adjusted for risk should outperform fixed income in 2022, given current and targeted 10-year yield levels (the 10-year Treasury at 2% in 12 months). Indeed, the CAPE yield gap versus real yield remains quite higher when compared to past pre-crisis levels.

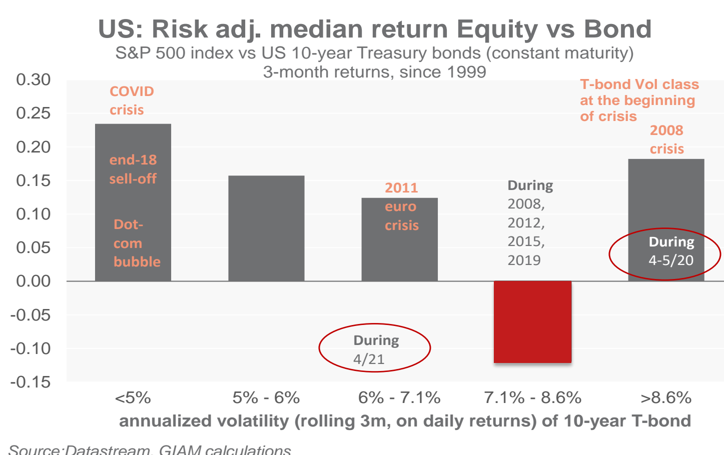
The problem is the increased volatility of future returns

Persistent volatility in the bond market would hurt the most

To begin with, volatility of fair value is associated with the less predictable response of monetary policy to high-for-longer inflation. Secondly, confidence indicators have peaked, adding to the uncertainty caused by a lower fiscal and monetary support. As a result, financial conditions and excess liquidity are normalising, pointing south, while PEs most probably will continue to shrink next year, after their compression by 10% already achieved year-to-date (average of EMU and US). Volatility should also drift



Source: Datastream, GIAM



Source:Datastream, GIAM calculations

higher. Furthermore, during a higher inflation range, the average risk premium demanded by investors did not change significantly in the last decades. But the standard deviation of the same risk premium did, increasing by nearly 40 bps, which corresponds to a ±5% in fair value. Finally, recently surged bond volatility has reached a level at which historically equity return vs. bonds starts suffering. In sum, we recommend a cautious OW on equities, favouring a barbell (Value + defensive growth). Financials and energy benefit from higher yields and inflation, decent GDP growth and undervaluation. We also OW defensive growth sectors as confidence is peaking and policy support declining. They deserve structurally high total return adjusted for risk – Sharpe ratio. OW: banks, insurance, cons. durables, energy, food, HPP, and pharma. UW: RE, div. financials, telecom and utilities. Our OWs all score well in terms of cycle phase, quant model results, valuation and revision trends. We also slightly OW EU vs. the S&P 500 given the very high spread recently reached in relative valuation.

EM equities: neutral stance warranted

EMs should respond to the China's easing measures with a time lag

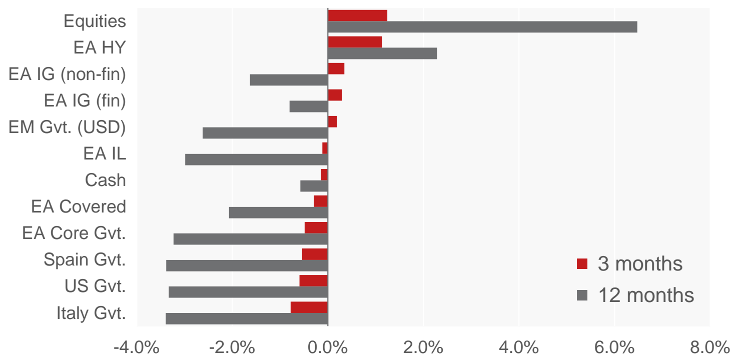
EM macro surprises seem to have bottomed out and should be supportive for the EMs in the short term. Additionally, there is a positive gap between EM performance and US financial conditions. That said, we continue to see weaker earnings and further headwinds that are represented by slowdown in China and high real interest rates. On the positive side we see extreme underperformance vs. the MSCI World (Z-score of -1.85), low relative valuation (0.9 stdev below average) and future better domestic growth plus higher policy support. Increasing Korean export growth and China's RRR cut bode well for Korea and Chinese A-shares (both OW, good country score). We stay neutral on MSCI China.

ASSET ALLOCATION

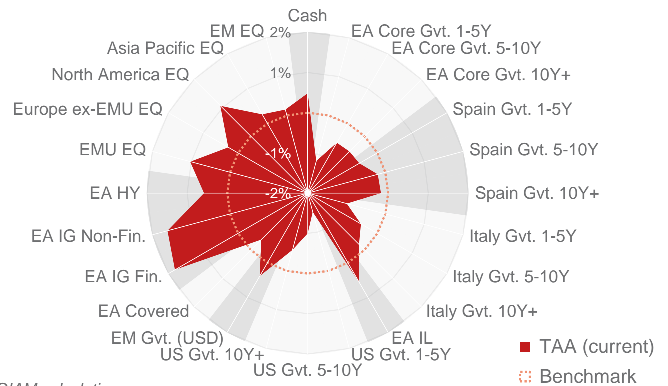
Thorsten Runde

- **In general, the global recovery story has worked well in 2021, making the year a successful one for risk assets and our allocation recommendations. That said, the setbacks in summer (Delta) and recently (Omicron) reminded us of financial markets' prevailing vulnerability with respect to bad Covid news.**
- **In 2022 last year's development should basically continue although at a slowing pace against the backdrop of policy withdrawal and persisting inflation. Policy uncertainty and worries about Covid-19 are expected to add to market volatility across the board.**
- **Given this setup, risk assets should be once again delivering positive returns well into 2022. For Equities and EA HY this should hold for the whole year, whereas EA IG should at least stay attractive in relative terms over government bonds, given the higher carry.**
- **Thus, we recommend starting into 2022 with a sizeable overweight in Credit and a bit more prudent one in Equities at the expense of Government Bonds. We trim the short stance in duration to reduce the risk associated with an unexpected early shift of the cycle from "expansion" to "slowdown".**

With the euro area experiencing the fourth Covid wave (also the highest one in terms of new cases) there can be no doubt that the virus and its mutations will be with us in 2022 too. Although vaccinated people might still be infectious, they are suffering less severely from the disease. Thus, with vaccination rates rising further, the pandemic might lose some of its scare, paving the way for effective alternative treatments and allowing governments for more targeted and concentrated response measures avoiding broad lockdowns. Evolving from a comprehensive market driver to a risk factor the pandemic should not derail the softening recovery in 2022.



Source: GIAM calculations



Source: GIAM calculations

Therefore, the favourable environment for risk assets basically remains intact. Yields are expected to rise, more in the medium term when uncertainties about Omicron hopefully vanish. Persistent inflation risks potentially fostering an accelerated monetary policy normalization could weigh on yields as wells as on spreads and Equity prices, thus, primarily adding to volatility.

We recommend starting into 2022 with a sizeable overweight in Credit and a bit more prudent one in Equities at the expense of the Government Bonds. An ongoing positive momentum in earnings should ensure positive albeit volatile Equity returns throughout the year. Credit might suffer as yields start to rise more significantly but remains attractive in relative terms from a carry perspective. We trim our short duration stance to a minimum to shield against an early tightening policy in the EA.

FORECASTS

Macro Data

Growth	2020	2021		2022		2023
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	- 3.4	5.7	0.2	3.9	- 0.1	2.1
Euro area	- 6.5	5.1	0.1	4.4	0.1	2.0
Germany	- 4.9	2.6	- 0.1	3.9	- 0.4	1.6
France	- 8.0	6.9	0.4	4.0	0.2	1.8
Italy	- 9.0	6.4	0.3	4.4	0.2	1.6
Non-EMU	- 7.4	5.9	- 0.0	4.2	- 0.0	2.1
UK	- 9.7	6.9	- 0.0	4.7	- 0.0	2.1
Switzerland	- 2.5	3.4	0.0	3.0	0.0	1.4
Japan	- 4.5	1.9	- 0.3	2.8	- 0.2	1.4
Asia ex Japan	- 1.0	7.0	- 0.1	5.1	- 0.4	5.1
China	1.9	7.8	- 0.2	4.8	- 0.3	5.3
CEE	- 1.7	5.9	0.2	3.6	0.2	3.5
Latin America	- 8.5	5.9	0.0	2.3	0.0	2.5
World	**- 3.4**	**5.8**	**- 0.0**	**4.2**	**- 0.1**	**3.3**

Inflation	2020	2021		2022		2023
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	1.2	4.5	0.1	4.7	1.0	2.7
Euro area	0.3	2.4	- 0.0	2.3	- 0.0	1.7
Germany	0.4	3.1	0.1	2.5	0.0	1.8
France	0.5	1.7	0.0	1.8	0.0	1.2
Italy	- 0.1	1.8	0.0	1.5	- 0.4	0.6
Non-EMU	0.6	2.1	0.1	3.1	0.2	1.9
UK	0.9	2.5	0.1	4.0	0.3	2.1
Switzerland	- 0.7	0.5	0.0	0.7	0.0	0.8
Japan	- 0.0	- 0.2	- 0.0	1.1	0.4	0.2
Asia ex Japan	2.8	2.1	- 0.1	2.8	0.1	2.7
China	2.5	0.9	- 0.1	2.3	0.2	2.1
CEE	5.5	9.2	- 0.2	10.5	2.7	7.3
Latin America	3.2	8.0	1.5	4.3	0.8	3.2
World	**2.1**	**3.5**	**0.0**	**3.8**	**0.5**	**2.8**

Regional and world aggregates revised to 2015 IMF PPP weights; Latin America Inflation excluding Argentina and Venezuela

Financial Markets

3-month LIBOR	Current*	3M	6M	12M
USD	0.20	0.15	0.40	0.60
EUR	-0.61	-0.60	-0.55	-0.55
JPY	-0.08	-0.10	-0.10	-0.10
GBP	0.09	0.25	0.50	0.75
CHF	-0.78	-0.80	-0.75	-0.75
10Y Government Bonds	**Current***	**3M**	**6M**	**12M**
US	1.45	1.50	1.65	2.00
Euro-Area	-0.36	-0.35	-0.20	0.10
France	-0.02	0.10	0.20	0.45
Italy	0.90	1.05	1.25	1.65
Japan	0.05	0.05	0.10	0.15
UK	0.72	0.80	0.95	1.25
Switzerland	-0.32	-0.30	-0.15	0.10
Spreads	**Current***	**3M**	**6M**	**12M**
GIIPS	99	110	110	115
BofAML Covered Bonds	47	50	50	55
BofAML EM Govies (in USD)	314	295	300	300

Corporate Bond Spreads	Current*	3M	6M	12M
BofAML Non-Financial	99	95	90	95
BofAML Financial	98	95	90	95
Forex	**Current***	**3M**	**6M**	**12M**
EUR/USD	1.13	1.11	1.12	1.14
USD/JPY	114	115	113	111
EUR/JPY	128	128	127	127
GBP/USD	1.32	1.31	1.33	1.34
EUR/GBP	0.85	0.85	0.84	0.85
EUR/CHF	1.04	1.03	1.05	1.08
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	4,672	4,710	4,790	4,945
MSCI EMU	149.8	152.0	152.5	157.0
TOPIX	1,976	1,985	2,010	2,070
FTSE	7,247	7,300	7,350	7,490
SMI	12,524	12,600	12,570	12,950

*as of 14.12.21 (3-day-average)

FORECASTS

Forecast Intervals*

3-Months Horizon

Group	Asset	Low	Forecast	High
Government Bonds (10Y)	US	1.19	1.50	1.81
	Germany	-0.53	-0.35	-0.17
	UK	0.44	0.80	1.16
	Switzerland	-0.49	-0.30	-0.10
Spreads	10Y-GIIPS Spread	89	110	131
	BofAML Covered Bonds	41	50	59
	BofAML IG Non Financial	231	95	359
	BofAML IG Financial	69	95	121
	BofAML EM (in USD)	63	295	127
Forex	EUR/USD	1.08	1.11	1.14
	USD/JPY	112	115	118
	EUR/GBP	0.82	0.85	0.87
	EUR/CHF	1.01	1.03	1.05
Equities	S&P500	4,398	4,710	5,022
	MSCI EMU	140.0	152.0	164.0
	TOPIX	1,847	1,985	2,123
	FTSE 100	6,798	7,300	7,802
	SMI	11,855	12,600	13,345

12-Months Horizon

Group	Asset	Low	Forecast	High
Government Bonds (10Y)	US	1.45	2.00	2.55
	Germany	-0.29	0.10	0.49
	UK	0.65	1.25	1.85
	Switzerland	-0.37	0.10	0.57
Spreads	10Y-GIIPS Spread	73	115	157
	BofAML Covered Bonds	38	55	72
	BofAML IG Non Financial	182	95	418
	BofAML IG Financial	48	95	142
	BofAML EM (in USD)	37	300	153
Forex	EUR/USD	1.08	1.14	1.20
	USD/JPY	104	111	118
	EUR/GBP	0.80	0.85	0.90
	EUR/CHF	1.05	1.08	1.11
Equities	S&P500	4,363	4,945	5,527
	MSCI EMU	134.8	157.0	179.2
	TOPIX	1,805	2,070	2,335
	FTSE 100	6,550	7,490	8,430
	SMI	11,554	12,950	14,346

*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5-year history of percentage changes, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the three-month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

IMPRINT

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